For release upon delivery
11:15 a.m. DST
Thursday, May 8, 1958

THE NATURE AND SCOPE OF MONETARY POLICY

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of the
Federal Reserve System

at the

38th Annual Conference
National Association of Mutual Savings Banks
Boston, Massachusetts

Thursday, May 8, 1958

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The best use to make of public finance either to stimulate or to restrain economic activity will always be a subject of wide debate. Against the present background of economic recession, the debate has focused on how to promote business recovery by bolstering spending. On the side of Federal fiscal policy much has been said about the pros and cons of tax reductions and public works programs to encourage spending. Much less has been said about the use of Federal Reserve System monetary policy to sustain and expand economic activity through its influence on spending.

Generally speaking, consumer spending is considered the most important of all types of spending because it serves not only to prime our productive machinery but, in doing so, to set its total output at varying levels that shape a myriad of subsidiary activities that, in turn, decide the economic state of the nation. For consumer spending to perform its economic function at maximum efficiency, its forces must maintain a proper balance between the kinds of activities that go with producing and distributing the output of our national plant and those that center around creating new or improving old plant capacity. From time to time throughout modern economic history this balance has become temporarily unsettled whenever plant capacity has been overbuilt in relation to existing needs. And when this has happened, the withdrawal of the manpower previously engaged on its construction has adversely affected consumer spending and consumer purchasing power. New sources of spending must then be induced that will restore the lost consumer purchasing power and redress the balance.

There is some evidence in the current business situation that the American economy may now be moving through one of these historic economic cycles resulting from a temporarily overbuilt plant capacity. It is, therefore, incumbent on all elements in public and private life to bend their efforts and exercise their ingenuity in ways that will help round off the ragged edges in the business situation, and in so doing put in place a firm foundation on which to build sustainable economic growth. Because credit is one of the economic factors whose end result is spending, its proper use for both public and private purposes is essential to the fulfillment of these aims.

In a free enterprise economy public finance, in either its fiscal or monetary aspects, enters into the individual choice of alternative forms of credit and the extent of their use by influencing the economic climate in which credit decisions are made. For example, consumers are less willing to use their credit and to go into debt when they are uncertain about their near-term economic security, and under such conditions the urge of industrialists to set up new facilities to cater to consumer needs also lessens. To help achieve an evenly balanced economy, therefore, requires the adoption of public credit policies that take practical economic advantage of the relationship between changing consumer attitudes and their effects on commercial and industrial activity.

An explanation of how the kinds of credit policies that are related to public finance can be used most advantageously in the public interest at a time of contracting economic activity first calls for a definition of the term "credit." It is fair to say that there are two distinct uses of the term. The first has to do with the kind of credit that is represented by loans and investments that have been made out of the supply of accumulated savings, while the second has to do with the kind of newly created credit that is generated by the lending and investing activities of the commercial banking system. Mutual savings banks, savings and loan associations, and insurance companies deal in the first kind of credit, but the scope of their lending and investment operations is influenced vastly by the credit-creating activities of the commercial banks. This is so because there is a dynamic force inherent in the creation of commercial bank credit that affects the tempo of all economic activities in ways that have a bearing on the supply of savings available for use by the credit-granting institutions referred to.

It follows in natural sequence that as the lending and investing activities of these institutions are influenced by the credit-creating activities of the commercial banks, and as the conduct of commercial banking is influenced by Federal Reserve System monetary and credit policy actions to regulate the volume of commercial bank credit, Federal Reserve System monetary and credit policy, at least remotely, exerts a controlling influence over the use of every kind of credit. Realization of how much the ability of consumers to save, or their willingness to spend, depends on the immense number of business transactions that are financed by commercial bank credit, lights up the far-reaching economic effects that flow from the power of the Federal Reserve System to regulate the volume of commercial bank credit through the supply of reserves on which it is based.

At the Federal level of using public finance to bolster spending, fiscal policy takes its place by the side of monetary policy as an economic agent capable of exerting a strong influence on business activity. In the realm of fiscal policy, both the tax and debt management functions of the United States Treasury are of great importance to economic stability and growth. At the present time, the relationship of fiscal policy and Federal Reserve System monetary policy is closest at the point of the debt management functions of the

United States Treasury which, by affecting the conduct of Federal Reserve System monetary policy, influence not only the lending and investing policies of the commercial banks but those of the mutual savings banks, savings and loan associations, and insurance companies. For example, taking its past policies as criteria for the future, the Treasury from time to time might be expected to offer securities calculated to appeal to the investment needs of the credit-granting institutions that operate through the use of savings. If, on such occasions, alternatively attractive investment choices should be available as between new or outstanding United States Treasury obligations and other types of public and private obligations (including real estate mortgages covering residential, commercial, and industrial properties), Federal Reserve monetary policy can then be employed to exploit the situation for national economic advantage. This is so because Federal Reserve System monetary and credit policy can link the savings based credit-granting activities of mutual savings banks, savings and loan associations, and insurance companies to those of the commercial banks so as to help stimulate economic activity when, as now, it is a purpose of policy to do so.

The actual link is made through the mechanism of the national debt by virtue of the fact that the supply of bank reserves, through which the Federal Reserve System regulates the volume of commercial bank credit, originates principally out of transactions in United States Government securities. Moreover, as the savings based credit-granting institutions, the commercial banks, and the Federal Reserve Banks are all investors in Government securities, and as the types of these securities held in their investment portfolios are constantly changing, the debt management policies of the Treasury are tied into the potentiality of Federal Reserve System monetary policy to regulate not only the volume of commercial bank credit, but to influence the investment policies of the savings based credit-granting institutions to the end of fostering economic stability and growth.

The record of Federal Reserve System policy actions going back to the fall of 1957 offers a practical demonstration of how the scope and influence of monetary policy can be extended beyond the commercial banking system, on which it falls primarily, toward secondarily exerting an influence on the investment and loan decisions of the various other credit-granting institutions that have been referred to. Beginning at that time, additional reserves were supplied to the commercial banks in steadily increasing amounts. Inasmuch as loan demand in the economically critical commercial and industrial sector of their lending had subsided, the commercial banks used some part of the new reserves placed at their disposal by Federal Reserve System policy actions as the basis for making customer loans to finance the purchase of new issues of United States Treasury, municipal, and corporate obligations whose proceeds exerted spending effects that substituted for those that had originated from previous direct commercial bank lendings for somewhat comparable purposes.

However, their greatest use has been to support a major expansion of direct commercial bank investments in outstanding and new issues of United States Government securities. Between investing directly in Government securities and, to a lesser extent, in other types of eligible public and private fixed-interest obligations, and lending to finance the distribution of the heavy volume of new security issues coming onto the market, the commercial banks are contributing massively to the momentum of the kinds of economic activities that have their origins in the acts of spending that flow out of the proceeds of securities transactions. The purposes of most of this spending can be identified with making the physical additions to our school and other public facilities, and the improvements in our commercial and industrial plants, that are so necessary to our national well-being and which have been translated in the process of their construction into new consumer purchasing power and spending.

Moreover, where some part of the commercial banks' additional investments have come out of the diversified portfolios of mutual savings banks, savings and loan associations, and insurance companies, the result has been to release savings resources back to these institutions for discretionary investment use in whatever channels were then considered to be best suited to their individual needs. This, in practice, has meant increasing their real estate mortgage loans and investing in new issues of United States Government, public, and corporation securities, the proceeds of which have flowed into the spending stream with beneficial economic effects corresponding to those resulting from the credit activities of the commercial banks.

It is through the kinds of developments that have been reviewed that Federal Reserve System monetary policy, by assisting the commercial banks to expand their loans and investments, at the same time opens new investment opportunities to the credit-granting institutions operating through the use of savings and, in combination, forges a link between the financing activities of both groups that is economically helpful, especially when business conditions are slack and need stimulation.

In considering the broad subject of savings and investment, it goes without saying that interest rates have a profound influence on investment decisions, and out of the entire complex of interest rates the discount rate of the Federal Reserve Banks has a key importance. This is true not only because it is the interest rate that governs the cost at which member banks can borrow from the Federal Reserve Banks, but because changes in the discount rate are a significant guide to money market conditions and the direction of Federal Reserve System monetary policy. Considering that investment decisions are framed in part against calculations as to whether interest rates will tend to become more or less attractive for investment purposes, it follows that a change in the Federal Reserve Bank discount rate has great significance. The reason for this is that where a change in the discount rate brings it into line with a past movement of other market rates of interest, a kind of official confirmation is given that the Federal Reserve System recognizes the validity of the existing interest rate structure both as the product of its own monetary policy and of market influences.

A change in the discount rate thus acts as a sort of green light to go ahead with investment actions that otherwise might have been held up pending clarification of interest rate conditions. A change in the discount rate can also be made as a red light to advise investors of some marked shift in economic conditions which they should pause to consider. A change in the discount rate on such occasions generally has the characteristic of leading rather than following the market movement of interest rates. Under all circumstances, it is clear that Federal Reserve Bank discount rate changes are a decisive factor for making Federal Reserve System monetary policy effective.

In many ways discount rate changes are of greater significance to the credit-granting institutions employing savings in their operations, and who invest at long-term, than to the commercial banks whose investments are concentrated at short-term. Altogether, there is little question but that Federal Reserve System monetary policy profoundly influences the investment policies of mutual savings banks, savings and loan associations, and insurance companies, and that influence is registered directly through changes in the Federal Reserve Bank discount rate and indirectly through a derivative influence on their activities that stems from the effects that monetary policy first has on the credit-creating activities of the commercial banks.

The thread of this discussion has been woven into the background of economic recession and has concentrated on the part that Federal Reserve System monetary policy can play in fostering economic growth and stability. The theme has been developed that a broad use of all forms of credit exerts a strong influence over economic activity and that monetary policy is a great force in determining the credit actions of all of the major financial institutions that deal in one form of credit or another.

Although the use of credit for stimulating economic activity lay at the heart of this discussion, we must not forget that only a short time ago it was deemed advisable to aim Federal Reserve System monetary policy at restricting the expansion of credit in order to mitigate the unstabilizing economic effects that arise from its too extensive use. The thought that remains from studying the effects of wide fluctuations in the volume of credit is that Federal Reserve System monetary and credit policy can exert a helpful, but not conclusive, influence over the uses to which credit is put. The factor that in the long run will always determine whether credit will be used to social and economic advantage is the human equation. Essentially we are our own masters over the use of credit. It is up to us to determine whether it shall be used constructively or recklessly, and we stand to win the rewards or to reap the whirlwind of our own decisions.