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Monetary Tools and Capabilities

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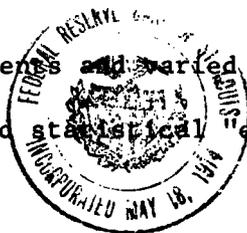
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Monetary Tools and Capabilities

This seemed to me an appropriate occasion to share with you some reflections and speculations on current attitudes toward monetary policy, its tools and capabilities. From my vantage point there appears to have been in recent years an increasingly keen professional interest in re-examining the nature of monetary processes, the linkages between monetary action and the real world, and the possibility of using monetary tools in a more sophisticated and selective way. This interest is evident within and without the Federal Reserve System. Among the academic economists whose work is illustrative are Lee Bach, Lester Chandler, James Duesenberry, Milton Friedman, Allan Meltzer, Franco Modigliani, Arthur Okun, and James Tobin. Within the System a similar list would include Daniel Brill, Richard Davis, Fred Deming, Jr., Frank DeLeeuw, Herbert Furth, Lyle Gramley, Robert Holland, Homer Jones, John Kareken, and Robert Solomon.

A central theoretical problem engaging the attention of several persons in the foregoing list, as well as many others, is the nature of the linkages between monetary action and the ultimate goals sought by monetary policy--relationships that are not well known or even adequately understood. This is hardly surprising for it is extremely difficult to measure empirically the impact of monetary action taken in a changing environment where numerous forces are affecting the economy. It is only when monetary action is so overwhelming as to dominate other economic forces at work that most observers, looking at the data, might agree that far too much or far too little money creation has been a necessary and sufficient condition for the occurrence of inflation or deflation.

Different environments and varied dosages of monetary action provide a wide range of empirical and statistical "evidence" as to the role of monetary policy.



One could argue, for example, that it makes little or no difference at what point or in what form the central bank introduces liquidity into the economy. Once introduced, money and credit promptly flow to those sectors where needed, and disturbances can occur only when the total provided to the system proves either insufficient or excessive. If insufficient, the need for additional money or credit becomes immediately apparent in the form of further demands for central bank accommodation, and can be satisfied by whatever injection is deemed technically convenient. If excessive, the only policy action required is to reduce or stop further injections or, if inflationary pressure has been permitted to build up, to withdraw money and credit from the system, again in any technically convenient way.

But these operations become vastly more complex once the assumption of complete flexibility in the financial system is abandoned. It is quite possible to find an excess of liquidity in one sector, or in one form of liquidity, and simultaneously a deficiency in another. And it is possible to find the banking system enlarging and shrinking its role as a financial intermediary as its competitive efforts wax and wane.

In these cases, a general increase or contraction in liquidity, worked through the banking system, is unable to cope with the problems of the economy, and it becomes vitally important to remedy an imbalance in the correct form and in the correct sector.

Thus we may find the natural preference of most central bankers and economists to use the general and quasi-automatic mechanisms of the economy giving way to methods that strike at the special problems more directly. Since we live in an economy where subsidy, statutory constraint and large-scale productive and distributive combinations, some with monopolistic tendencies, are common, direct monetary methods can hardly be regarded as "out of context." Selective treatment of particular problems should not be dogmatically rejected without considering the unsought hurt that a general policy might work in channels where constraint or expansion is neither called for nor consistent with broader public policy.

These comments on attitudes toward monetary policy point to the need to explore more fully the relative merits of the principles of generality and selectivity. This exploration means thorough analysis of the famous problem of linkages--the way in which money and credit flows are connected with the behavior of banks, business, and the public in general; and the way in which central bank action influences that connection. The monetary research program of the Federal Reserve System, both at the Board and at the Banks, is now being specially directed to these problems, and I hope that it will lead not merely to better theoretical insights but also to important practical applications.

Meanwhile, however, central banking policy will need to proceed on the assumption that both general and selective measures have their place in

the system. Hence, I shall briefly consider two problems of general monetary policy--technical improvement and anti-inflationary action--and later touch on the more numerous problems of selective policies.

General Monetary Policy

The first question, which concerns both the technical efficiency of general monetary policy and its use as an anti-inflationary tool, refers to the relation between monetary policy and fiscal policy.

The old idea, according to which monetary policy affects primarily credit and thus investment while fiscal policy affects primarily income and thus consumption, has recently, in some quarters, been supplanted, or at least supplemented, by the idea that monetary policy affects primarily the international, and fiscal policy primarily the domestic sector of the economy. The basis of this thesis is the postulate that, under the assumption of complete mobility of international capital, any fall (rise) in interest rates--which under the further assumption of perfect domestic capital markets is associated with any substantial increase (decrease) in the availability of credit--would make investment abroad more (less) attractive and therefore immediately lead to an outflow (inflow) of funds.

This seems to open the way for the solution of any domestic and international financial problem simply by changing the "mix" between monetary and fiscal policy. If a country were suffering from domestic inflation and international deficit, for instance, the first ill would be cured by a tightening of fiscal policy and the second by a firming of monetary policy--the classical recipe for such a situation. But if a country were suffering from lagging domestic growth and international deficit, as the United States has done for part of the most recent period, some would argue the remedy

would be a combination of expansionary fiscal with firming monetary policy. To some extent, such a new "mix" is actually to be found in U.S. policies during the past two years; but the thesis has not been carried to its ultimate conclusion, and I, for one, believe that there are good reasons for not doing so.

First of all, international capital flows are influenced by many economic factors other than interest rate differentials. Market imperfections, differences among countries in financial structure and sophistication, and governmental regulations all play a highly important role in determining the international flow of capital. Moreover, a considerable part of international capital flow takes the form of equity investments, including both direct acquisition of real assets abroad and purchases of foreign shares. Certainly, the attractiveness of equity investment abroad, in either of these forms, can vary quite differently from the movement in interest rates.

Still, while the new theory of the "mix" cannot be accepted in its entirety, there is room and need for further study of the relationship between the tools of monetary and fiscal policy, and of the possible variations in the appropriate "mix." For instance, an expansionary fiscal policy, by creating or increasing a budget deficit, will necessitate an increased flow of investable funds into Treasury securities, and therefore--unless supported by easier monetary policy--will in itself tend to raise interest rates. Econometric studies may show whether the inhibitive impact on investment of the rise in interest rates is likely to have smaller, equal, or greater multiplier effects on total economic activity than the stimulative impact on consumption of the rise in disposable income. Another important and related question for the econometrician is the relative contractive effect

of a rise in interest rates on the domestic flow of funds and on the capital outflow when the former is more than 10 times as great as the latter.

The second question refers to the age-old controversy about the impact of monetary policy on cost and availability of credit. Obviously, the problem would not arise if financial markets could be assumed to be so perfect that any change in availability would produce a definite change in cost, and vice versa. Even in imperfect markets, it would be helpful if we had even a proximate measure of availability and if we could accurately measure to two or three significant places the level of interest costs in bank lending. One could also argue that the most orthodox economic theorist should concede that all prices are formed within a region or penumbra; that the intersection of demand and supply curved forms a zone on a plane rather than a point.

If this is true, the relevant question has two parts: first, how large is this penumbra in which measurable costs may be changed without affecting measurable supply, and measurable supply may be changed without affecting measurable costs; and, second, how do the various traditional tools of general monetary policy differ among each other in their relative impact on cost and availability?

The third question relates to the technical efficiency of the three traditional tools of monetary policy. The efficiency of changes in discount rates depends importantly on the willingness of member banks to borrow from the central bank, or on a tradition to change administered market rates in sympathy with changes in the discount rate. The efficiency of open market operations depends on the efficiency of the securities market. And the efficiency of changes in reserve requirements depends upon the

extent to which lenders are subject to such requirements--in the United States, for instance, on the relative importance of member and nonmember banks, and of the commercial banking system as a whole and other types of lending institutions.

It seems quite possible that, in the United States, the efficiency of all three instruments of general credit control might be increased, both by changes in the Federal Reserve Act and by changes in the administration of the existing legal provisions. Much innovative thinking along these lines does not see the light of day, and shouldn't. But, at the same time, I feel we may be too constrained by the heavy layer of ancient traditions and conventional wisdom that encrusts both academic and central banker views. For this occasion only, I am going to try to shake free that handicap for a few minutes and, leaving aside the wise, old, experience-tested limits on central bank action, discuss some alternative guidelines which would change our ways of dealing with various monetary problems. Some may sound prosaic, others may have an unreal ring to them, but I would hope that in the aggregate they would, at least, suggest some new and useful perspectives to you.

Suppose we begin with the discount window. Casting off the idea of keeping "the tradition against borrowing," the discount window could be made a more effective instrument for putting reserves directly where needed within the banking system by making loans to member banks in larger amounts and for longer periods whenever community demands for funds for seasonal or other purposes dictated.

The discount mechanism would work more smoothly and less incongruously with respect to present-day banking practices if the statutory restrictions as to eligible paper were repealed and advances were made on the basis of any appropriate collateral, or even on an unsecured basis where warranted

by the quality of the bank's loans and investments and its capital and liquidity position. Another innovation worth considering would be widening the scope of open market operations to include other debt instruments than Treasury securities. As the money markets, in particular, have broadened, new instruments have come into use and the Open Market Account Manager is gradually being forced to deal in a smaller and smaller relative sector of the entire market that is relevant to the Committee's objectives and operations.

Selective Monetary Policies

Although our present system of monetary action is clearly based on preference for generality, it has significant selective aspects, even apart from the margin requirements for security credit. Selectivity is in another guise, however, and its impact on broad policy goals could almost be called inadvertent. Reserve requirements, for example, are differentiated by location of bank (a crude proxy for size), by type of deposit (demand or time), and according to the membership in the Federal Reserve System and State of incorporation. This differentiation is aimed at certain structural goals, the equalization of competitive conditions--or in some instances at nothing at all. Nonetheless, some selective effects on broader goals have doubtless resulted.

Though open market purchases are usually thought of as a method of reserve creation which is general in its impact, they are not neutral among a family of assets that could be alternatively used for the same purpose. System purchases of coupon issues in connection with "Operation Twist" illustrate the selective possibilities and the side effects on primary operating goals of varying the type of asset to be held in the System portfolio.

Discounting policy is also thought of as completely general, but its selectivity is manifested in the rules that define the terms under which the privilege of obtaining Federal Reserve credit can be exercised.

In pointing out that generality in monetary operations does not exist in the pure form often alleged for it, I should note that specific measures will usually have some effect on the general goals. Either type of tool has some of the dominant characteristics of the other.

The Federal Reserve has for a long time been concerned about ways to render the selectivity of reserve requirements more rational. In the case of differentiation among banks, reserve requirements might be graded according to the bank's deposit volume rather than according to its location--a change that, incidentally, would recognize the difference in competitive potential between large and small banks.

Differentiation by type of deposit has been deprived of some of its meaning by the emergence of a variety of time deposit forms, ranging from short-term marketable CD's to long-term savings bonds which give their holders differing degrees of liquidity plus interest yields. Reserve requirements conceivably could be varied for different types of time deposits but they can hardly be raised much as long as similar funds held with nonbank institutions are exempt from all such requirements. Here again, the question of improving the structure of monetary mechanism becomes entangled in the political problem of the extent of central bank influence on the country's financial institutions.

The main application of selectivity in monetary policy is not to be found in bank location, bank size, or of type of deposit but rather in the credit-granting function of banks. Monetary policy aims primarily at influencing the cost and availability of credit through the supply of bank reserves, but as banks vary their earning-asset holdings in response to changing reserve availability they can impinge selectively upon a number of different credit markets. Such selectivity needs to be recognized, and it may lead to selective countermeasures if the end result is not in accord with over-all public policy goals. When selective measures are used for this purpose, they typically differentiate among various types of bank assets rather than among various types of bank liabilities: for example, stock exchange credit under Regulations T and U, instalment credit under Regulation W, mortgage credit under Regulation X, and credit to foreigners under our voluntary restraint program.

General monetary policy is vulnerable to the accusation that it does not, and can not, distinguish between credits that are likely to maximize the full employment of our productive resources, and those that will make minimal contributions in this respect. It would be difficult if not impossible to make an operational a priori distinction between those two categories; but by and large, it could be argued that long-term credits, as they have been used, tend to promote investment more than short-term credits, and that credits to domestic borrowers tend to raise the level of domestic economic activity more than similar credits to foreigners. The latter distinction becomes particularly important under circumstances like those obtaining for the past several years, when a payments deficit involving a very large outflow of capital existed side by side with domestic

underemployment. Hence, the main problem confronting selective monetary policy-- and perhaps the most serious problem confronting monetary policy in general-- relates to the possibility of devising selective measures that have different, and perhaps opposite, effects on short-term and long-term credits, or on credits to foreign and to domestic borrowers.

Short- and long-term credits--Discount policy, as hitherto practiced, tends also to have a selective effect: since Federal Reserve lending is typically short-term, banks are, to that extent, encouraged to favor short-term asset holdings in order to be in some position to liquidate such debt as required. This Federal Reserve lending practice has been justified as a means of promoting and protecting the liquidity of commercial banks. But it deprives the Federal Reserve of a tool for inducing shifts in banker emphasis between short-term and longer term lending, when such shifts would patently serve the public interest.

Open market operations can be used for differential effects on short- and long-term credit conditions by means of the "twist," i.e., simultaneous opposite operations in short- and long-term securities. By means of "twist" operations it is possible, for instance, to keep money-market rates higher than they otherwise would be, say, in order to attract volatile funds from abroad, while keeping long-term interest rates lower than they would otherwise be, say, in order to promote domestic investment.

But "twist" operations have a serious limitation. The term structure of interest rates and the relation between demand and supply of credit funds of different maturity generally can only be dominated by central bank action for a limited period of time. If market forces were tending to establish a

pattern of interest rates markedly different from that aimed at by the central bank, it would have to engage in continuous and massive open market sales and purchases--an operation that could interfere with the achievement of some other goal--either contemporaneously or in the future. It is true that the operations of the central bank would in many circumstances influence market expectations as to the near-term relationship of long to short rates, but the fact remains that when the market judgment as to appropriate rate relationships differs substantially and persistently from that of the central bank, the power of the latter to affect the pattern is limited.

Hence, a substantial and enduring influence on the relative cost and availability of short- and long-term credit can be exerted only if the central bank is able to modify the relative profitability of the two types of credit independently of market reactions. Such influence could be exerted through any or all of the conventional monetary mechanisms. Reserve requirements, for example, might be based on types of assets rather than deposits, i.e., if the central bank wished to encourage long-term rather than short-term lending, it could impose additional reserve requirements on short-term credit accommodation in excess of a given percentage of its total assets--or conversely to reduce reserve requirements for long-term credit extended in excess of a given percentage of its total assets. Obviously, in our monetary system such action would require an amendment of the Federal Reserve Act.

Credits to domestic and foreign borrowers--While it can be reasonably argued that under current conditions selectivity between different types of domestic credits is not essential for a smooth working of the economic system and that the allocation of funds between domestic short- and

long-term credits can be left to market forces, there is little doubt that the market allocation of funds between domestic and foreign uses has worsened our balance of payments problem. The stability of the international payments system as well as adequate growth of our domestic economy have for years been jeopardized by the tendency of U.S. lenders to grant credits and corporations to invest abroad greatly in excess of the amounts that would have been compatible with full employment and payments equilibrium.

This is not the place to go into the economic, political, and institutional reasons for the disequilibrium between credit and capital yields in the United States and other industrial nations, which lies at the root of the excessive outflow. We may hope that this disequilibrium will disappear in due time and that the international allocation of credit and capital then will proceed with the same tolerable degree of efficiency and rationality as the allocation of funds within the United States. But until this happy stage is reached, I am afraid that selective measures may remain necessary in order to avert excessive outflows of U.S. capital to the surplus countries of Continental Europe.

At present, such selective measures include the IET and the voluntary credit restraint program inaugurated in accordance with the President's message of February 10, 1965. Both of these measures have disadvantages for the long pull--the one is confined in application and relatively inflexible, the other is by its nature of limited duration.

Should we be looking forward to more durable and efficient technique? So far as banks are concerned there is the possibility of using a system of selective monetary measures, such as specific reserve requirements for credits to foreigners. This system could be flexible enough to differentiate between

various regions--less developed and fully-developed countries, Western Hemisphere and rest of the world, countries dependent on or independent from U.S. credit and capital--or even, but with some lesser hope for effectiveness, between various purposes--financing of U.S. exports, of development programs, of foreign subsidiaries of U.S. firms--or between various forms of credit--liquid funds, short-term credits, long-term credits, equity investments, and so on.

A significant objection to a technique of this type is its limitation to member banks. Nonmembers and nonbank lenders should be placed under a similar restraint if such a method of dealing with the capital outflow were used. Political and practical difficulties would be posed by such an undertaking, and I do not want to give the impression that I know the answers to all the questions that could and should be raised in this connection. Certainly we should be wary of any avoidable step that might take us to the strict Government regulation of foreign payments. The fact that the regulating power would be vested in a central bank and be exercised through monetary policy rather than through direct controls would not eliminate the inherent risk to maximum possible freedom of international commerce. But in the absence of international agreement on a better world monetary system, we may well have to choose from among an assortment of essentially repugnant methods in order to restore balance in the international payments of the United States and the international monetary system in general. Selective monetary policies may well turn out to be a lesser evil than the others.

Conclusions

One thing, I hope, emerges clearly from this brief review of some of the problems of monetary policy: whatever else we may be lacking, we do not lack new challenges. Some of the departures from traditional central banking mentioned, not necessarily advocated, I hasten to say, in my paper may, upon closer examination, prove unnecessary, or undesirable, or outright harmful. But I believe that at least some of them may point a way to a more rational and more efficient use of monetary policy. And even if not a single one of the ideas set forth today were ever to see the light of practical experimentation: I hope that those of you who entered this room convinced that central bankers are staunch supporters of orthodoxy and unable to grasp or consider novel ideas, will--if they did not decide to leave while the going was good--have found out that even the most stolid of all professions is subject to the law of eternal change and, we hope, eternal progress.