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Some Current Problems of Monetary Policy

Remarks of George W. Mitchell

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## Some Current Problems of Monetary Policy

When I accepted your Program Chairman's invitation to be in Atlanta today it seemed desirable to have a fail-safe title for my remarks-- neither too confining nor too demanding on my resources, neither too dull nor too exciting to your expectations. We came up with "Some Current Problems of Monetary Policy." It covers everything and promises nothing-- the latter is perhaps more important to me as no one likes to find himself in a state of obvious "flunkedness." I once heard Jimmy Ernst say "It is far easier to compose a stimulating, provocative speech title than it is to compose the speech that lives up to it"--an aphorism which he proceeded to demonstrate. I obviously am not under that constraint today.

However, as the time for delivery of this speech drew near the more obvious facets of my wide-ranging topic seemed less and less worth our time and attention. What more is there for me to say than one can read in the daily newspaper about the problems of monetary policy that are implicit in unfolding economic and financial trends?

Is there an unseasonal chill descending on the private economy?

Have interest rates reached and passed their cyclical highs?

Will Vietnam spending escalate further?

Have banks, prodded by the Federal Reserve, brought business loan growth to a standstill, or are faltering business loans bringing bank growth to a standstill? Or is it that bank growth is the victim of necessitous disintermediation brought on by interest rate ceilings on time deposits which disadvantage banks because the yields on marketable securities and ceiling rates on savings and loan association shares are higher?

Is the balance of payments getting worse because our trading position is deteriorating, or is it getting better because of the large short-term money inflow that has been taking place? Was the little spurt in money supply growth back in May-October, 1964, associated with the surge in GNP in the fourth quarter of 1965 and first quarter of 1966--about 16 months later; and did the let-down in money supply growth early in 1965 presage the falling off in GNP in the second quarter of 1966--again, nearly 16 months later?

If the relationship between these phenomena is more than coincidental, what should we be expecting of GNP late in 1967 and early in 1968 in light of the fact that money supply has shown no growth in the past six months?

In time we may well have the answers to all of these and like questions--as of now I could, for the record, only speculate about them, as can anyone else. But, unlike most economists, I have a special handicap, not too widely shared, of possibly having something to do with the answers to some of these questions. The inhibiting effect of responsibility does not make for free-flowing prognostication.

Under my protean speech title I had thought I could also discuss the pros and cons of moderating economic expansion by using Federal fiscal action to supplement or supplant monetary action, as the case may be. Now that the selective impact of general monetary restraint has been so widely observed, if not shared, there is a certain yearning for some anonymity in the linkage between policy actions and economic consequences. How nice it

would be to have a gentle diffusion of policy effects--felt by none, but influential on all. It is too much to expect, however, that restraint will go either unnoticed or unchallenged. Quite naturally we from the Federal Reserve who have had our finger--and perhaps even more of our anatomy--in the dike for a year or so would welcome fiscal action, either as a replacement or an ally in the task to be done.

But a speech along this line would be "old hat" for you and, in a way, self-serving for me. I concluded, therefore, that for this audience it would be most appropriate to unveil some of the monetary planning now going on at the Federal Reserve--planning which we hope will make our future monetary actions more timely, more precise and more certain and, hence, less unnecessarily disruptive to our financial framework and institutions. Perhaps it comes as a surprise to you to know that the Federal Reserve plans ahead, just as do those who build cars, space vehicles, or cities. We are now researching the guidelines for monetary policy in future periods of ease and restraint, and how tools of monetary policy can be adapted or invented to best serve the needs of the economy of tomorrow.

The most far-reaching basic research currently underway is an organized attempt to fill the gaps in our knowledge about the processes through which monetary policy influences the general economy. For short, we call this "linkage" research.

The influence of financial factors on the demands for goods and services is doubted by few economists, but there is either uncertainty or disagreement as to which financial variables are the most influential, through what channels--financial and real--they exert their influence on

spending and saving decisions, the magnitude of their influence, how long it takes for this influence to be effective, and how their magnitude and timing varies at different stages of the business cycle. Nor is there an entirely satisfactory understanding as to the processes by which the monetary policy actions of the Federal Reserve itself affect the financial variables which, in turn, act on the real economy.

Our research in this area is based on the belief, or at least the assumption, that an adequate model of the quantifiable monetary influences on the economy must deal with both the balance sheet and income accounts of consumers, businesses and financial institutions. I think it is fair to say that, within the existing range of uncertainty, a majority of monetary economists have arrived at a roughly similar working consensus as to how monetary instruments influence aggregate demands for goods and services and, through them, such ultimate policy variables as employment, production and growth. This is commonly referred to as the "portfolio" approach to monetary influence.

Views of Professor Friedman and others that concentrate on money supply influence on GNP are, it seems to me, less widely credited. Nor are the pure Keynesian macro-models generally accepted, since they deal almost entirely with the income accounts of participants in the economic processes, treating balance sheets only in a very fragmentary way. The spending behavior of consumers and businesses in these models reflects monetary variables only by including in their equations some interest rates and perhaps a few liquidity variables. It is our feeling that monetary policy works its effect on the economy partly through disturbing balance sheet

equilibria, and that these disturbances are adjusted in complex ways that include, but are not confined to, changes in the flows of funds reflected in the income accounts.

Let me hasten to say that our current emphasis on work in this area does not imply that the research staffs in the Federal Reserve System have just awakened to the need for a better understanding of monetary processes. In a sense, the Fed has been doing linkage research all its life, just as Moliere's M. Jourdain discovered that he had been writing prose for 40 years. But Federal Reserve research into the linkages between monetary action and ultimate economic effects is now being organized more systematically and pursued with more modern techniques. In particular, the current effort represents the System's first big entry into the wonderful world of econometric-model building and large-scale use of the computer in such model building.

Our initial approach to "linkage" research was in the best of Federal Reserve System tradition--we appointed a committee. It was chaired by Dave Eastburn of the Philadelphia Reserve Bank. This group brought forth a charter for our research efforts at understanding monetary processes entitled, "Linkages Between Monetary Policy and the General Economy: A Framework for Research."

With this charter at hand, we tapped three sources of analytical talent. One group, comprised of economists from both the Board's staff and the staffs of the Federal Reserve Banks, went to work on severable and manageable segments of the monetary processes as described in the charter. Another group was brought into being by beefing up our in-house staff at the

Board of Governors to develop an econometric model of the economy that was oriented very closely to what we considered to be the needs of a monetary authority. And a third approach to the problem was organized by financing, through the Social Science Research Council, work by academic monetary economists in the area of the impact of financial variables on various sectors of the real economy.

A few words about each of these approaches. Our System-wide efforts have involved five working forces. One group, initially chaired by John Kareken of the Minneapolis Reserve Bank and the University of Minnesota, and now by Richard Davis of the New York Reserve Bank, currently on leave at Princeton, was given the job of developing a model or framework for the entire linkage process all the way from a specific Federal Reserve action to the ultimate goals of monetary policy.

Now, ideally, we should have stopped right there and waited for the model to be constructed before we started testing its many relationships. But since we knew this would be a long and difficult job and since we also felt pretty sure that we could identify some of the relationships that would no doubt turn up in any model, we set up four additional working groups, each of which was deliberately charged with taking a partial rather than an over-all approach, at the same time the over-all model was being constructed.

One of these task forces is concerned with linkages among money market variables. It is headed by Robert Holland of the Board's staff. More specifically, this group is seeking to establish the relationships among Federal Reserve open market operations in Government securities, various short-term interest rates, and other indexes of money market conditions and reserve utilization by the banking system.

Another group is concerned with links between money market variables and more basic financial variables. This group, headed by Maurice Mann of the Cleveland Reserve Bank, is studying the links between changes in bank reserves and such other financial variables as demand deposits, currency in circulation, time deposits, bank credit and longer-term interest rates.

Still another group is concerning itself with the relationships among the real variables in the economy. Wilbur Billington of the Kansas City Reserve Bank is heading this group and it is focusing on the relationships among such ultimate goals of monetary policy as high employment, production, sustainable economic growth and reasonable price stability.

A final group, which is just getting off the ground and which is headed by Robert Solomon of the Board's staff, is concerned with the relationships between domestic financial conditions and international capital movements.

The work of the in-house staff of the Board and that of the academic economists associated with the SSRC is gradually converging. Both are now involved in the construction and testing of a 50 to 60 equation quarterly model of the U.S. economy. The main purposes of such a model are to aid in short-term forecasting and to establish the likely effects of alternate monetary policies on major economic aggregates. It will be used to supplement, and in conjunction with, the judgmental models we currently use in our policy formulation.

Our in-house work on an over-all model is mainly under the direction of Frank de Leeuw. Incidentally, let me work in a recruiting plug here. We are in the market for several good, young econometricians. If you know of any such people who would be interested in getting involved in our

exciting linkage work, Daniel Brill, Director of our Division of Research and Statistics, would be most pleased to know about them.

Our Social Science Research Council work was originally under a committee headed by James Duesenberry of Harvard, now at the Council of Economic Advisers, and Franco Modigliani of MIT. This committee contracted several studies on the influence of financial variables on various types of expenditures. This work is still going on and, more recently, we are also sponsoring a larger research project led jointly by Modigliani and Albert Ando of the University of Pennsylvania on the construction of the model to which I have referred earlier.

It is still too early to say anything about the over-all results to date of our work. Some time next year we hope to have constructed a model and to have begun to fit the pieces involving the various observed relationships among specific variables into the over-all framework.

In the meantime, though, several individual pieces of the work have been completed. Some of these have been summarized in the Federal Reserve Bulletin and are available in full in mimeographed form on request. Other papers will follow from time to time as they are completed.

In the System-wide work, research to date has focused on what someone has termed the "inside links," that is, those connecting variables over which the Federal Reserve has most direct influence and other financial variables. To cite just one example, George Kaufman of the Chicago Federal Reserve Bank sought to identify variables most closely related to past changes in the public's holdings of currency. Among all the variables he tested, he found that only changes in income and/or aggregate expenditures were consistently and significantly related to changes in currency.

An example of System work on relationships among the real economic variables is a study by Addison Cutler of the Cleveland Reserve Bank, which concerned itself with the relative roles of "demand-pull" and "cost-push" in commodity price movements in the late 1950's and early 1960's. He concluded, based on an analysis of data on prices and output of 188 product lines, that cost-push was relatively more important in the 1953-57 period than in the 1957-63 period, although even in the latter period the role of cost-push seemed to be far from negligible.

We have also done some work on the linkages between finance and the real economy. One paper by Jimmie Monhollon of the Richmond Federal Reserve Bank, for example, on manufacturers' inventory investment and monetary policy, has been summarized in the Bulletin. Another by Professor Resek of the University of Illinois on the effects of financial variables on investment in plant and equipment--one of several financed under our Social Science Research Council contract--is scheduled to be published shortly in the Review of Economic Statistics. The Monhollon paper found no significant direct relationship between the cost and availability of credit and inventory investment in the postwar period. The paper suggested, however, that the indirect effects of monetary policy through sales, unfilled orders and prices may be quite important to such investment. The Resek paper, on the other hand, produced some surprisingly strong evidence on the influence of financial factors such as interest rates and stock market variables on plant and equipment spending. Other work in our project is well advanced on the effects of financial variables on consumer spending, on durable goods, and on State and local government spending.

One final word about our efforts in this area of the relationship between monetary policy and economic activity. Our current research program is, I believe, a sizable step forward. It should provide us with much more quantitative information as to the many processes, linkages and relationships involved between specific Federal Reserve actions at one end of the line and the ultimate goals of economic stabilization at the other end. We very much need quantitative measurements to condition and to back up our judgments of appropriate policy.

The Federal Reserve System is also engaged in a comprehensive study of the discount mechanism. This study has sought to evaluate the working of the present system in periods when monetary posture is stimulative, accommodative or restrictive. While it is currently absorbing a large amount of System research effort it, too, is not oriented at present-day problems but rather at issues likely to be faced in the future. Thus, it is examining prospective changes, ranging from small technical improvements to major revisions in the discount mechanism and rationale.

The present discount function operates under Regulation A, which was last revised in 1955. The changes in the economic and financial environment that have taken place in the intervening ten years--such as the decline in bank holdings of easily marketable assets, the growth of markets for certificates of deposit and Federal funds, and the evolution in bank attitudes and practices toward borrowing--were motivating factors in undertaking the current study. That the present mechanism is perhaps not well suited to current conditions has been suggested by criticisms and questions raised both within and without the System as well as by the small scale of System lending.

Participation in this project has involved staff and officials from many parts of the System. The Steering Committee is composed of representatives from the Board of Governors and Presidents of the Reserve Banks; the research is being directed by top-level official staff personnel at the Board and the Banks; staff economists and technicians have been working with academic consultants as well as the staffs of foreign central banks. More than 25 separate research studies have been completed or are in process.

Studies to date have made it clear that for discounting purposes we cannot regard our banking system as homogeneous. It is, rather, a collection of 14,000 individual units, of which about 6,000 are members of the Federal Reserve System, and among whom some 700 of the largest are, for practical purposes, *sui generis*. These latter banks all actively deal in Federal funds, and about 200 of them are directly and continually in contact with the Nation's central money market. All other banks, while constituting about 95 per cent of the banks in the country, hold only about 30 per cent of total deposits, and account for an even smaller proportion of the fluctuations therein. Discounting is at times vitally important to the smaller banks, but the total volume of their borrowings is relatively unimportant for over-all monetary policy. It is within the group of larger banks, and especially the money-market banks, that changes in the aggregate volume of discounting can importantly affect the bite of national monetary policy.

We have found it useful to think of discounting as made up of two dimensions, which might be described as operational and strategic. The operational includes meeting those needs for reserves which are caused by such factors as random short-falls from projections, seasonal patterns of loan demand, and deposit losses. These needs appear in almost all banks at some time, and are presumably not created, nor importantly affected, by changes in monetary policy. This is the sort of discounting upon which the 1955 Regulation concentrated.

The strategic dimension of discounting includes borrowing which comes about as the result of monetary pressure and this is the sort of borrowing that accounts for most of today's aggregates. In practice, of course, the two dimensions of discounting often blend together. The operational needs increase somewhat during periods of restraint, and, probably more important, other means of adjustment become less readily available.

It seems reasonable to expect that the discount window will continue to assist banks in meeting their purely operational needs, a task for which it is uniquely suited. However, various improvements in the way it meets them are under consideration. Also being examined are possible ways of easing these needs by mechanisms other than the discount window--for example, the possibilities for changes in reserve period accounting or the fostering of secondary markets to ease flows of funds among banks.

Also being discussed is the possibility of the discount window assuming some of the responsibility for operational reserve adjustments now performed by open market operations. These would be somewhat different from the above in that they would involve offsetting some of the short-term,

reversible movements in reserves which are also largely unrelated to monetary policy, but which affect the economy as a whole as well as any individual bank.

Another question that has been raised is the possibility of the window taking a more active part in carrying out the thrust of monetary policy. As the proportion of reserves supplied through the discount window increases in periods of restraint, more banks are under pressure to adjust, and thus the restraint is transmitted throughout the banking system. Possibilities for improving and strengthening this mechanism are being discussed.

A question which overrides all considerations of discount window use is how to control it. The extent of borrowing is now controlled primarily by bank reluctance to borrow and, when this is not effective, by administrative counseling. The discount rate serves only a subsidiary role. This system has been the target of much criticism; various changes have been suggested. The academic experts would have us rely almost exclusively on rate. Other suggestions are for quantitative limits, such as lines of credit or possibly an auction of funds, or some more positive variation of administrative control. All these possibilities are being considered within the framework of the study, as are numerous other combinations. As of now, no clear consensus has begun to emerge other than the sense, based largely on our own and foreign experience, that it would be unwise to give up a tool we have, or to wed ourselves exclusively to any one control mechanism which may become inappropriate in future circumstances.

These are but a few of the areas of inquiry within the discount study, but they perhaps give you some idea of its scope and the range of changes in the mechanism which it may produce.

A final thought which I would like to leave with you concerns the relationship between the economic profession and the Federal Reserve System. I do not think I can overstate the importance of your understanding of our problems and our understanding of your potential contribution to their solution. It is, of course, true we have always learned from each other, raided one another's intellectual resources and scoffed at each other's foibles of fact or theory. But, I think the time is coming when your responsibility for contributions to monetary theory and practice should weigh more heavily on you. After all, your guild now holds four out of seven seats on the Board and we need your support!

I should report to you that in the past three years the Federal Reserve has heard a good deal of wise counsel from a series of academic seminars sponsored by the Board, held in Washington, and dealing with current monetary issues and selected economic problems affecting the future course of monetary policy. These seminars, held three or four times a year, are arranged by Professor Lee Bach of Stanford University. Professor Bach selects the topics with some consultation with us and arranges on his own responsibility for a dozen or so academic participants at each meeting. The attendance response from economists from all over the country has been as close to 100 per cent as busy schedules permit and the intellectual response to the problems presented has consistently strengthened our grasp of the difficult issues we must face. This is the most concrete evidence I can advance that the guild is not letting us down.