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Elfun Society of G. E.
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THE FEDERAL RESERVE AND MONETARY POLICY

Our discussion this evening centers on the Federal Reserve System and its role in shaping national monetary policy. Before talking about monetary policy, however, I'd like to give you a glimpse of the structure of the Federal Reserve, then a vignette of the men who serve as Directors of our Bank, and finally a bit about the service functions we perform for member banks and the public.

The Federal Reserve Bank of Cleveland is part of the central banking system of the United States. Along with the eleven other Reserve banks it functions in part as a service institution, and in part as the monetary authority of the United States.

The Federal Reserve System was created 52 years ago by an Act of Congress to provide an elastic currency and to prevent periodic panics which resulted from the perverse elasticity of the money supply under the old national banking system.

At the apex of the System stands the Board of Governors of the Federal Reserve System -- a Government agency appointed by the President with the advice and consent of the Senate. The Board is independent of the Executive, but is responsible in a broad general way to Congress. The Congress has delegated to the Federal Reserve the day-to-day responsibility for regulating the money supply, which was delegated to the Congress by the Constitution.

Next in the hierarchy stand the twelve regional Federal Reserve banks, which are half public, half private. Their stock is owned by the 6,000 member banks of the System. The member banks receive fixed dividends of six percent on non-transferable capital stock. They do not have a proprietary interest in the Reserve banks, and do not have a residual claim on the Reserve banks' earnings or assets. They do, however, have the right to elect six of the nine directors of their Federal Reserve bank.

I should like to talk a little about our Board of Directors, its major responsibilities and how its members are chosen, and to indicate the caliber of the men who serve as directors.

Our directors meet on the second Thursday of each month to review business and credit conditions and to take such action as is necessary in connection with the affairs of the bank. They establish the discount rate of our bank (the rate paid by member banks who borrow from us), subject to the review and determination of the Board of Governors of the Federal Reserve System in Washington. The directors advise the presidents of the twelve Reserve banks on national credit policies and thereby perform an important public service.

Like each of the eleven other Federal Reserve banks we have nine directors, divided into three classes, designated A, B, and C. The Class A and B Directors are elected by member banks for three-year terms. The three Class A Directors are usually bankers, and by law can be officers in a bank and hold bank stock. The three Class B Directors are actively engaged in commerce, agriculture or industry, and by law can hold bank stock but cannot be bankers.

The Board of Governors appoints the three Class C Directors who are regarded as the "public" members. The Governors designate one of them as Chairman and Federal Reserve Agent and another as Deputy Chairman. Class C Directors can neither hold bank stock nor be bank officers. In effect, Class A Directors are lenders, Class B Directors are borrowers, and Class C Directors represent the general public. Now for the introductions, beginning with the Class C Directors:

JOSEPH B. HALL, Director and former Chairman of the Board of The Kroger Co., Cincinnati, is our Chairman and Federal Reserve Agent for the Fourth Federal Reserve District.

LOGAN T. JOHNSTON, Chairman of the Board of the Armco Steel Corporation at Middletown, Ohio, is our Deputy Chairman.

The third Class C Director is ALBERT G. CLAY, President of the Clay Tobacco Company of Mt. Sterling, Kentucky.

The Class B Directors are:

WALTER K. BAILEY, Chairman of the Board of Warner & Swasey here in Cleveland.

DAVID A. MEEKER, Chairman of the Board and Chief Executive Officer of Hobart Manufacturing Company of Troy, Ohio, and

EDWIN J. THOMAS, Chairman of the Executive and Finance Committee of Goodyear Tire & Rubber Company of Akron.

The Class A Directors, all of whom are bankers, are:

RICHARD R. HOLLINGTON, President of The Ohio Bank and Savings Company in Findlay, Ohio, and also a member of a Cleveland law firm.

EVERETT D. REESE, Chairman of the Board of The City National Bank & Trust Company of Columbus, who is the newest member of the Board, and

SEWARD D. SCHOOLER, President of the Coshocton National Bank, Coshocton, Ohio.

I might add that we have two branches -- one in Cincinnati and one in Pittsburgh -- and each of these has its own board of directors. Once each quarter all of us get together and exchange views and opinions -- much as you do in the Elfun Society.

We are all justifiably proud of the men on our Board, and we are indebted to the many fine communities in the Fourth District that supply men of such high character and accomplishment who serve so well the banking business and the public.

The Federal Reserve System is not dependent upon the Congress for appropriations. The Reserve banks make a huge profit, most of which, after operating expenses and modest dividend and surplus requirements, is turned over to the United States Treasury. Last year our bank earned over \$110 million, paid dividends of about \$2.9 million, transferred \$2.6 million to surplus and paid the remaining \$105 million over to the U. S. Treasury. The comparable figures for all twelve Reserve banks are: earnings, \$1.35 billion; dividends, \$32 million; transferred to surplus, \$27 million, and paid to the U. S. Treasury, about \$1.3 billion.

The assets of the Federal Reserve Bank of Cleveland at the close of last year totaled about \$5.4 billion, and the total assets of the twelve banks in the System aggregated \$63 billion. Thus, our District represents about eight percent of the System total. We are the largest financial organization in the District.

You might wonder where the money comes from that we operate on and pay to the Government. Only a very small fraction -- about 1.3 percent -- comes from interest on loans we make to member banks. The great bulk of it comes from interest on Government securities that the Federal Reserve banks, operating as a System, have purchased in order to supply reserves to member banks.

Before I get into the techniques of monetary policy, I should like to outline briefly some of the service functions performed by our bank for member banks, the U. S. Treasury, businesses and individuals. Most of the 1,435 employees at our main office and branches are engaged in service operations. Among these service departments are:

(1) Our Check Collection department, which last year processed 412 million items, with a face amount totaling more than \$131 billion -- an all-time high.

(2) Our Cash department, which in 1965 paid out 4,500 tons of coin, and over \$2.3 billion in currency.

(3) Our Fiscal Agent department, which performs many services for the U. S. Treasury, including the issuance of E bonds for payroll plan savers, the issuance and redemption of other Treasury issues, payment of coupons on U. S. Treasury bonds, the collection of withheld taxes from employers, and the destruction of unfit Treasury currency.

(4) The transfer of funds and U. S. Government securities over private wires of the System at a saving in time and cost to all.

(5) The safekeeping of securities owned by member banks, and the purchase and sale of Government securities for member banks and public bodies.

(6) The maintenance of a staff of trained examiners who make unannounced detailed examinations of state member banks at least once a year, and

(7) The collection and distribution of research and statistical information concerning industry and agriculture in the District.

So much for general background information about the Federal Reserve System and our bank. Now let's turn to monetary policy -- the primary responsibility of the System. We have three main tools as instruments for implementing monetary policy:

(1) Required reserve ratios, set by the Board of Governors in Washington. These are the percentages of their deposits that member banks must keep on deposit with their Federal Reserve bank as reserves. The present ratios for demand deposits -- that is, checking account money -- are 16 1/2 percent for large city banks and 12 percent for other banks (so-called country banks), and 4 percent of savings and time deposits, for all banks. Any change in the required reserve ratios is a very "blunt" instrument. A change of one percentage point, for instance, provides the basis for expansion or contraction of bank credit of several billions of dollars. This tool, because it is so blunt, is used very infrequently.

(2) The discount rate, which is the rate of interest member banks must pay when they borrow from the Fed. This rate is set by the directors of each of the twelve Federal Reserve banks every two weeks, subject to approval by the Board of Governors. The present rate of 4 1/2 percent has been in effect since December, when it was raised from 4 percent.

(3) Open Market Operations. This is by far the most flexible and frequently used tool for implementing monetary policy. First I want to give you a bird's-eye view of the overall operation, and then, in some detail, give you a worm's-eye view of what goes on behind the scenes in this important phase of policy making.

Open market operations are conducted by the Federal Open Market Committee, which meets in Washington every three weeks to determine monetary policy for the next three weeks. The Committee is composed of the seven members of the Board of Governors and five Federal Reserve bank presidents. The president of the New York bank is a permanent member; Cleveland and Chicago Feds alternate every other year -- currently, I am a voting member -- and the other nine banks rotate every three years.

At each meeting the Board members and Federal Reserve bank presidents summarize the credit needs of the economy as seen from their respective areas and vantage points. A consensus is then agreed upon by the voting members and a directive is given to the Manager of the System Open Market Account, who operates from New York. To ease credit he buys Government securities in the open market, thus increasing bank reserves; to tighten credit he sells securities, thus decreasing bank reserves. Each \$1 million of Government securities purchased in the open market provides a reserve base for an expansion of about \$7 million in demand deposits, or for about \$25 million in time deposits. Because of these high expansion ratios, deposits held at the Federal Reserve banks by member banks are called "high-powered" money.

The Committee's work is basic to the main task of the Federal Reserve System, which is to establish money and credit conditions that will help to achieve the broad economic goals of our country. These goals are a healthy expanding economy, stable prices, maximum employment, and a favorable balance of payments.

I would like now to give you some idea of how we do the job -- how we formulate monetary policy to achieve national goals, and then how we implement it. I will touch upon the framework of policy making, how decisions are made, the flow of information that supports the policy-making process, the role of decentralization or regionalism, and how I, as president of the Cleveland bank, fit into the general picture. Although my role seems important to me, I am actually a very small part of a very large organization. What I am about to tell you can therefore best be interpreted as a worm's-eye view of central banking.

At the center of the policy-making process, as I have indicated, is the Federal Open Market Committee, commonly called the FOMC. While only five of the Reserve bank presidents are voting members at any one time, all twelve of the presidents are expected to attend the tri-weekly meetings of the Committee for two reasons: First, to keep the Committee fully informed of what is going on in the various Districts and, second, to assure that the Committee will have the most competent regional thinking on the formulation of monetary policy.

Each president comes to the meetings fully briefed by his research staff; each president has tapped the knowledge and judgment of members of his board of directors and of his branch boards of directors; each president, in addition, regularly talks to business and banking leaders in his area, who often contribute important insights into business and financial developments as they occur, and sometimes even before they occur -- in either event, well before they are reported in the national statistics compiled in Washington.

The presidents thus bring a wide variety of background information to the FOMC meetings, where this material is fused with other more global, or aggregative data, to serve as a basis for official policy. I might add that each president has his own point of view -- whether it is in interpreting current developments or in judging what policy ought to be. When the FOMC finally reaches a consensus -- after all the presidents, the governors, and the official staff have had their say -- it is, in my opinion, a reasonable and balanced judgment, based on the very latest and most detailed information available throughout the nation. Also, in my opinion, the functioning of the FOMC is an outstanding example of how a decentralized and regional system can contribute to sound and balanced policy making for our vast and complex nation. The presidents are close to the grass roots and have a close feel of the local situation. The national board in Washington is near the processing centers for the preparation of broad aggregative data, and is adept in interpreting these measures. Thus, policy is formulated on the basis of both local and national information, of both specific and general data. On the whole, this system has worked well and has contributed importantly to our country's growth and stability.

From my own personal standpoint, I feel strongly that I have a very serious responsibility as a member of the FOMC -- as do the other presidents, and, of course, the members of the Board of Governors. I feel it is my duty to go to Washington as fully informed and as well prepared as possible, within my physical and mental limitations.

The focus of all this might be clearer to you if I told you how we at the Cleveland bank prepare for a meeting of the FOMC. Our procedures here are really quite simple to describe. Although we continuously study the course of economic events, about a week before each FOMC meeting we move into high gear. The research staff prepares a comprehensive, up-to-date background report on economic developments -- locally, nationally, and internationally. The essence of all of this is simmered down and distilled into a fifteen-page summary, which my staff has dubbed the "tri-weekly" (to reflect the frequency with which they have to prepare it). Special memoranda are also prepared by individual staff members on topics that appear to be of overriding and timely significance, for example, on prices, quality of credit, and so forth. In addition, the staffs of the Board of Governors in Washington and of the New York Reserve Bank send us reports on significant economic developments at home and abroad. Thus we have a comprehensive evaluation of national and international developments, and a close reading of regional developments as well. Our research department makes a particularly detailed analysis of regional industries that are of major significance in interpreting national developments; for example, steel, autos, machine tools, and the like.

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The staff is always trying to develop new techniques of analysis and special or new kinds of data to improve our evaluations -- sometimes as a result of my "needling", but more often on their own. For example, they have developed, with the cooperation of major steel producers in our district, a special series on new orders for steel. This gives us advance information as to what steel production and shipments will be in the months to come; and you know how important the steel industry is in explaining cyclical swings in the economy, as well as for the health of our part of the country.

In addition to these intensive studies within our shop, members of our staff maintain close contacts and have many discussions with business and banking people outside of our organization, other economists, market research analysts, and the like. Our senior staff members, in particular, attend many meetings with their counterparts in other organizations. Once a week they lunch with 15 or 20 other Cleveland economists, to exchange views on current developments and trends; once a month the five or six commercial bank economists in Cleveland come to our bank to exchange views on financial and banking developments; once every quarter Fourth District industrial economists spend a day at the bank reviewing in depth developments throughout the region and the nation. There are many other contacts too numerous to mention.

All of these bits and pieces flow together in a more or less steady stream to provide a deep reservoir of information that goes into the making of monetary policy. The various and sundry parts are put into a comprehensive whole, usually beginning on the Thursday prior to the FOMC meeting, when I sit down with the First Vice President and senior research officers to focus on the material that we have at hand. I have my own views, which I test on them. And, of course, I listen to others in the group. In effect, we hammer out (and I use the word "hammer" advisedly) a point of view -- a consensus -- of what we think the economy is doing and what we feel would be appropriate monetary policy. In the end, of course, I am the responsible party, but I don't reach my conclusions alone.

After the Thursday meeting, a draft of a position paper is prepared. We then reconvene on Friday and work on the draft, arriving at what we hope is a cogent, well-reasoned and analytically sound position paper to be used at the FOMC meeting on the following Tuesday. If new or different information becomes available before then, appropriate changes are, of course, made in the document, sometimes late into the evening of the night preceding the meeting.

I have discussed our procedures in some detail because they convey, to me at least, the true strength of the Federal Reserve System -- the fact that we are dealing with fact, not fancy or fiction. Our procedures allow us to check, to review, and to assess, not only what is happening in the economy, but as well, the impact of Federal Reserve policy on business, banks, and other financial institutions. The lateness of the publication dates of most national statistics is reason enough for us to operate as we do -- we need to know about things promptly as they unfold -- in fact, even before they unfold, if at all possible. Also, we need much more detail than is provided by the national statistics.

With similar procedures being followed at other Reserve banks and at the Board of Governors, it is not surprising that the deliberations of the Federal Open Market Committee are detailed and enlightening. In my own case, I feel strongly that I am contributing to these deliberations on policy making. If I didn't, I would not be at the Cleveland bank. It is the very nature of what I have described that convinces me of the strength of our regional decentralized system.

In a similar sense, the case is very strong for keeping the Federal Reserve independent. Independence of the Federal Reserve is essential to keeping policy making outside of the political arena. Moreover, the complexity of our economic affairs argues strongly for the type of objective process that we have.

"Independence," of course, does not mean "aloofness." The Federal Reserve is not independent of the Federal Government -- but is only independent within the Government. The Federal Reserve has been delegated the responsibility for carrying out monetary policy by the Congress; but that delegation does not cover all phases of governmental activity affecting the economic and financial climate. For example, the Treasury has vast powers in the international field and it is absolutely essential that the Federal Reserve and the Treasury work closely together on matters affecting international finance, the international balance of payments, and our gold position. Furthermore, it is essential that the Federal Reserve and the Treasury both conform to the requirements of the foreign policy of the United States as established by the President of the United States and his Secretary of State. The Treasury is also the biggest borrower in our country, and in our operations in the money market we can no more ignore the needs of the Treasury than a commercial bank can ignore the needs of its important customers.

The independence that we have in the Federal Reserve System, our regional structure, and the heavy and sobering responsibilities which the System bears, account for a large part of the successful record of the past 52 years -- and our healthy influence on the nation's economic life. It also helps to explain the fundamental strength and resilience of the Federal Reserve System as well as the high caliber of the people who serve it.

Thank you all very much.

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