

Economics Club
Yale University
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Monetary Policy PUB-1

The subject of this talk is Federal Reserve Policy. I want to spend part of my time on a series of points currently discussed in connection with monetary policy and the balance on the record of policy actions during the period 1951 through 1959. I see no particular point in talking abstract monetary theory to you; you get, I take it, reasonably thorough discussion in that area in your regular work.

In effect, with respect to the policy record, I want to say "this was done; this is why it was done" from the point of view of a central banker. To make this as factual and explanatory as I can, I have prepared a three-panel chart which shows some of the significant measures of financial and economic conditions. The policy review and explanation will be made mainly against that background.

Before going into detail on the policy record, however, it probably will be useful to comment on several points, some of which comment will touch lightly on the fringes of monetary theory. Some, if not most, of this comment may seem quite obvious to you. And yet I am struck particularly and almost continuously by the fact that a lot of the controversy over monetary policy apparently originates in forgetting, overlooking, failing to appreciate, or simply not recognizing some very obvious factors.

1. Monetary policy is not an all-powerful economic stabilization

weapon which, in proper hands and properly used, can eliminate the business cycle, produce a satisfactory rate of economic growth, keep unemployment to a fictional minimum and stabilize the general price level. No central banker that I know believes or advances this point. And yet a substantial body of criticism directed at monetary policy seems to be rooted in the proposition that any deviations in prices, increases in unemployment, slowing down of growth or level of activity are direct consequences of the failure of monetary policy to be carried out properly.

My colleague at Atlanta, Malcolm Bryan, once used a graphic analogy to make this point by comparing monetary policy with a wife who was beautiful, a good cook, a brilliant conversationalist, a fine mother and a talented pianist, but who was sued for divorce because she was physically unable to move the piano.

Without laboring this point further, I should say that I know that not everybody bases criticism of monetary policy on this approach. In fact, another substantial body of criticism seems to be rooted in a reverse proposition.

2. Monetary policy, in its present form, is of some consequence. The fact that prices rose substantially following World War II and edged up even after the Korean War impact was spent, that we had three dips in economic activity since World War II, that unemployment currently hovers just below

5 per cent, and that we did not match the Russian growth rate in the late 1950's, are cited as proof that monetary policy is impotent. In point of fact, the record since 1951 has been pretty good taken as a whole, as I shall try to demonstrate later.

Actually, of course, monetary policy is neither impotent nor all potent. It is an important stabilization device; it works best when other stabilization devices are used more fully than they have been over much of the postwar period.

And in this connection I want to underline a point that has been cited often but seems to be disregarded even more often. The record of history and, most strikingly, the record of recent history abroad would seem to demonstrate almost beyond challenge that sound, courageous, and well-timed monetary policy action, coupled with similar fiscal policy action, can and has contributed to high rates of real growth with reasonable price stability. Foreigners seem to be far less doubtful of the usefulness of monetary policy than we.

3. General monetary policy has selective impact on the economy.

This point seems to have been discovered fairly recently by a number of people who reason from it in two ways: (a) since this is so, why not use a battery of selective controls in place of general monetary policy and/or (b) the uneven impact of general monetary policy has social, economic, and political

costs it would be well to avoid by using some other device or devices to accomplish the same general purpose.

It is obvious that general monetary policy has selective impact on the economy. It is supposed to have. In theory, the individuals, businesses or sectors that find restrictive action adverse are those which are marginal performers. In a situation requiring economy of resource use, it is for the benefit of the economy as a whole to have resources go to more rather than to less efficient users.

The real questions here are whether the market mechanism does a better economic allocation job than would a non-market device and/or whether the social and political costs of the market allocation are too great to permit it to work. On the first point I have considerable doubt as to my virtues as an allocator as against the market mechanism under relatively normal conditions. On the second point, the question of social and political costs usually resolves itself into one concerning undue discrimination against various segments of the economy. I find the evidence of unfair discrimination against the three most cited sectors - small business, state and local governments, and residential construction singularly unconvincing. At worst, I would say that the discrimination case is the Scottish verdict "not proven".

Let me refer here briefly to only one of these fields - small

business. In the recently released staff report for the Joint Economic Committee Professor Smith of Michigan argues that there are plausible reasons for expecting small business to be discriminated against during periods of tight money and then fails, insofar as I can see, to give any such plausible reasons. He does note that if availability of credit is not a problem for large firms, an effective monetary policy must adversely affect small firms. He also cites the fact that interest rates on loans to big concerns moved up more percentagewise in the 1956-57 tight money period than rates on loans to small concerns. This is regarded as possible evidence of discrimination because it would make loans to bigger concerns more attractive.

The above line of reasoning I find most unconvincing. Far more plausible would seem to be the following line of argument. Most banks are small banks. Most customers of small banks are small businesses, farmers or individuals. Most small banks have lower loan/deposit ratios than most big banks; in other words, they have greater unused lending capacity. Big and middle-sized business seem to squeal just as loud as small business during credit stringency.

4. Now let us take a short side excursion into monetary theory - or perhaps I should say "theories". As you know there are a number of theories of interest rate determination which center on different, though not necessarily mutually exclusive, aspects of the process through which rates are set. Thus

some stress the savings-investment process, some stress cash balances and liquidity demands, some stress supply and demand for loanable funds.

The point I want to stress is that elements of all of these theories account for interest rate movements, as observed by a central banker, at particular circumstances of time and place and under particular institutional characteristics of the economy. Consequently monetary policy is made on a more pragmatic basis - it does not follow any given line of theory - Hawtry, Keynes, Friedman, Gurley - all of the time, but may well follow any one of these some of the time. Because there is no one well-defined and articulated theory upon which central banking action can be determined, some critics contend that central banking is really a mystique, and belief in its efficacy is more a matter of faith than of hard economic proof.

Part of this comment is, I think, justified. Central banking remains more art than science. This hardly makes it unique, however, in the field of economics or in the wider field of political economy. And the fact that precise determination of the effects of credit cost versus credit availability, of changes in the money supply versus changes in liquidity and velocity is not possible at this time, should not be taken to mean that the general linkage between monetary policy action and economic response is impossible to discern.

Quite obviously central banking action affects bank reserves, such reserves

form the basis of the money supply and underpin commercial bank loans and investments. Changes in these affect spending and saving of the various sectors of the economy. Questions of "how much", "how fast", and so on, have to be answered in the light of associated factors of liquidity, velocity, and so on, but they can be answered reasonably well at a particular point in time - they merely are not susceptible to formula treatment.

Just to leave this point on a more positive note, I should give you in broad outline a central banking approach to monetary theory. Over the long pull the demand for real investment must be matched by the supply of real savings. That is, these must match if we have high employment and a growing economy operating at or about at its current capacity. This is true because economic resources are scarce and in a capacity operation resources going for investment purposes have to be taken from consumption purposes and saving represents the withholding of spending from consumption.

Created money then can be no more than a relatively short-run substitute for savings in financing investment. It can bridge temporarily gaps between the flow of current savings and needed investment when real resources are available because the economy is operating below capacity. It is important, of course, that the money supply be allowed to grow as the total economy grows so that financing stringencies do not impede growth. But the money

supply (demand deposits and currency owned by the public) must be equal to the amount of cash balances the public is willing to hold at an appropriate rate of turnover. The greater the supply of other liquid assets, the less the volume of money needed to operate a given level of economic activity. And it is important to note that increases in the money supply cover only a small part of credit needs. Interest rates are a reflection of the interplay of demand and supply forces in the savings-investment process and are an essential allocative factor in the market rather than an element to be fixed by credit policy.

5. Few actions taken by the Federal Reserve System have been more controversial than the operational policy that has come to be called "bills only". It has been criticized most vociferously by a great many professional economists and by a good many people in the Congress. It is no secret that there has been some opposition to it within the Federal Reserve System. What I want to do here is to try to put the policy in perspective.

The policy is given in what we call "continuing statements of operating policy" and is stated as follows:

- a. It is not now the policy of the Committee to support any pattern of prices and yields in the Government securities market, and intervention in the Government securities market is solely to effectuate the objectives of monetary and credit policy (including correction of disorderly markets).
- b. Operations for the System Account in the open market, other than repurchase agreements, shall be confined to short-term securities (except in the correction of disorderly markets), and during a period of Treasury financing

there shall be no purchases of (1) maturing issues for which an exchange is being offered, (2) when-issued securities, or (3) outstanding issues of comparable maturities to those being offered for exchange; these policies to be followed until such time as they may be superseded or modified by further action of the Federal Open Market Committee.

c. Transactions for the System Account in the open market shall be entered into solely for the purpose of providing or absorbing reserves (except in the correction of disorderly markets), and shall not include offsetting purchases and sales of securities for the purpose of altering the maturity pattern of the System's portfolio; such policy to be followed until such time as it may be superseded or modified by further action of the Federal Open Market Committee.

I think it is important to note that within the System there is no objection to statement (a). Officially, within the System, only one member of the Open Market Committee has voted against statements (b) and (c) in recent years, and he has stated that if the word "solely" were changed to "primarily" in (c), and the phrase "as a general rule" were inserted in both (b) and (c), these would be acceptable to him. This is a matter of public record.

I think it is a fair statement that a number of people in the Federal Reserve now wish that the phrasing of these policies had been cast in a little less seemingly rigid form. I remember an English teacher of mine who used to say "Never use the word 'always' and always avoid the use of the word 'never'". When these statements were drafted that thought might have been considered. For one reason or another, however, it has seemed to most of the members of the

Open Market Committee unwise to change the wording since there is no intention to change the policy itself.

Actually the statements have been interpreted to be far more doctrinaire than people within the System ever understood them to be. With the Open Market Committee meeting every three weeks and with these policies coming up for review at any time anyone wants to bring them up, it is quite possible to change all or any of them at almost any time. There have been, of course, two major occasions when deviations from these policies were permitted.

I think it is also important to recognize that these operating policies command far more unanimity of support within the Federal Reserve System at the present time than they did when they were first introduced. At the time of their establishment there was far more question of their wisdom than there is currently. In large part this reflects the fact that as System authorities look back over the record they find little reason to justify intervention in the intermediate and long sectors of the market except in the two instances noted. You understand that this is a retrospective view; there have been times when, at the moment, such intervention looked more attractive, at least to some people within the System.

The theoretical case for this program is outlined quite well in a paper given by Winfield W. Riefiler at a meeting of teachers of economics in

the Ninth District at Minneapolis in the spring of 1958. That paper subsequently was printed in the Federal Reserve Bulletin. Riefler notes that there are three effects of open market operations: changes in the volume of securities in the market; changes in the volume of free reserves, and changes in expectations.

With respect to change in the volume of securities, the effect is 1 for 1. Prices and yields are affected most strongly in the issues traded, but there are arbitrage effects. With respect to free reserves, the impact is about 7 to 1 because of the fractional reserve system, and that impact is spread over all issues fairly rapidly. This effect is identical with the effect obtained from gold movements, reserve requirement changes, changes in the volume of currency outstanding, etc. With respect to expectations, which are primarily a factor on the professional side of the market, these can lead to fairly pronounced swings in prices and yields in the short run, which effects do not necessarily reflect real market forces. Dealings in bills lead to less extreme expectations.

There is a considerable amount of interchangeability and substitutability on both the demand and supply sides of the market which tend to generalize pressures or availability from one sector to all sectors of the credit markets. Banks are particularly important with respect to this

responsiveness because they operate across a wide range of sectors.

I believe there is no question concerning the feeling of the professional sector of the market on these operating policies. The recent hearings and questions sent out in connection with the Joint Economic Committee investigation brought almost unanimous opinion from government securities dealers that the "bills only" policy had strengthened the market and had put them in a position where they could take more of a position and thereby make for a stronger market.

From the standpoint of the System, the "put and take" of reserves via short term money market instruments is a natural operating policy for a central bank most of the time anyway. Most System operations are designed to offset or accent short-run or seasonal movements. In total, these are far greater in volume than any operations undertaken to provide for secular growth in the money supply. Operations in short term securities simply are convenient, are accepted without much feeling by the market and would account for the great bulk of transactions with or without a "bills only" policy.

I probably should note here that some of the objections to the "bills only" policy has come from some people, including some Congressmen, who have been opposed to it for what might be called all of the wrong reasons.

These people apparently believe that if the System conducted its transactions

along the entire yield curve, some support for long term government securities would result and this would have kept long term government rates from moving up to pierce the 4 1/4 per cent ceiling. In point of fact, of course, normal System action to hold down reserve growth in periods of inflationary pressure, if carried out in long term securities would have involved sales rather than purchases of such securities.

It seems to me the real point with respect to "bills only" comes down primarily to two questions. (1) Has the central bank deliberately tied its hands so that it is less effective than it could be? On this I think the record would have to be interpreted as yielding a rather firm "No" answer. In so far as I can see on the occasions when the policy was deviated from there was no hesitancy to vote for the deviation, and as I said earlier, as we look back there seems to be little case for intervention in the intermediate or long term sectors of the market. Even the second deviation looks less attractive in retrospect.

The second question has to do with approach. Should the central bank deliberately try to move interest rates, or should it try to let the market play the major role in the field. Here System opinion is pretty unanimous. We do not want to get back into the business of fixing interest rates. Most people who apparently would like to have the System follow this course seem

to be far more sure of what should be done and far more sure of the response of the economy to these actions than is any central banker.

In summary, I think my position on "bills only" is that (a) it is misnamed, (b) it has worked extremely well, and (c) I wish it were a little better understood.

6. Now, I would like to touch on one more point before getting into the policy record. This has to do with the question of required reserves. As you know, some people have argued - most recently a group of 21 Senators - that the Federal Reserve should take action to permit the money supply to grow more rapidly and this should be done via open market operations (preferably in bonds) rather than through reserve requirement reductions. The argument is that such purchases would increase System earnings, and since System net earnings go back to the Treasury this action would save the Government money.

My first observation on this proposal is that saving the Government money by taking action designed to increase Federal Reserve earnings is not really the way to run a central bank. The record is filled with horrible examples of central banks which regarded good earnings as an objective rather than a result of good credit policy. If the Congress thinks that commercial bank earnings are too high, it seems to me that the way to recapture these

is through taxes on the commercial banks rather than by directing the central

bank not to use one of its policy instruments.

But more pertinent points in connection with this matter are these.

There is a fairly strong feeling within the System that the level of reserve requirements is higher than it should be. We have been operating fairly close to the legal maximums for quite a long time. These ratios are substantially higher than those prevailing in most other countries. The central bank would have more leverage if the ratios were lower.

In addition, there is a basic inequity between reserve requirements of member banks and nonmember banks in this country. Given voluntary membership in the Federal Reserve System, the spread between nonmember reserve requirements and member reserve requirements is such as to discourage rather than encourage membership. This is not a major factor in the effectiveness of central banking in this country, but it represents a situation that is needlessly irritating.

Finally I think it should be noted that it is central banking opinion, and fairly strong opinion, that in times of recession quicker response to easing action can be obtained via reserve requirement reductions than via open market operations. You will note as we look at the policy record later on that over the past eight years there has been only one reserve requirement

increase. All the other moves with respect to reserve requirements have been decreases, and all of them took place during periods of lessening economic activity.