Introduction

In introducing the subject of monetary policy, I want to make three general observations. I do this for two reasons. First, they are so obvious they tend to be overlooked; and second, since they are often overlooked, their discovery at times tends to provoke undue emphasis or misinterpretation.

Following these general observations, I intend to review briefly past monetary policy, discuss equally briefly some aspects of open market operating policies and then speculate about current and prospective policy problems.

1. My first observation has to do with monetary theory - or perhaps I should say "theories". 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. Some theories stress supply and demand for loanable funds, some stress cash balances and liquidity demands, some stress the savings-investment process. What I want to stress is that elements of all these theories account for interest rate movements at particular circumstances of time and place and under particular institutional characteristics of the economy.

Monetary policy therefore has to be made on a pragmatic basis and cannot be tied to a particular theory. This should not be taken to mean that there is no conceptual framework for monetary policy but it should be taken to mean that central bankers cannot be guided exclusively by any one or an unchanging mixture of such factors as: the state of liquidity, the level of cash balances, the money supply, the volume of savings, the amount of investment, or the demand for loans. Central banking thus remains more art than
science, a fact that has brought forth criticism that it is really more mystique than method, that its impact and its results are uncertain and that its practitioners are committed to saying little because they know little to say.

Actually, of course, the fact that central banking is more art than science hardly makes it unique in the field of economic, political or social policy. 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 does not mean that the general linkage between monetary policy action and economic response is impossible to discern. Questions of "how much", "how fast" and so on can be answered reasonably well at a particular point in time - they merely are not, yet at least, susceptible to formula treatment.

2. My second observation has to do with the character of monetary policy. It is usually characterized as a "general" or "overall" economic control in contrast to a "direct" or "selective" one. Actually monetary policy has and is supposed to have a selective impact on the economy, a fact discovered only recently by some critics of monetary policy who tend to reason from it in two ways: (a) Why not use a battery of selective controls in place of a general control and/or (b) the selectivity of monetary policy has undesirable social, political and economic costs.

There is, of course, good reason to contrast the "general" with the "direct" or "selective" insofar as monetary policy is concerned since its selectivity is exercised through the market mechanism rather than through fiat, and, in theory and actuality, runs generally in favor of the efficient and against the marginal user of credit rather than against particular people or activities. In our type of economy, or in any type for that matter, economy of resource use is desirable since resources are limited.
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 economic, social and political costs are too great to allow it to work. On the first point the historical record seems to be on the side of using the market mechanism. On the second point, the question of undesirable costs resolves itself mainly into one concerning undue discrimination against one or more segments of the political economy. Here the evidence is mixed but, on balance, seems to indicate no undue discrimination. Certainly it does not prove discrimination.

3. My third observation is one I really need not make before this audience. Monetary policy is not an all-powerful economic stabilization device and good monetary policy does not automatically guarantee full employment, good growth rates and price stability. Monetary policy is important, however, and bad policy probably can almost guarantee against long-term maintenance of growth, high employment and price stability.

Review of Past Policy

To begin the review portion of this talk I want to go back 20 years, to the entry of the United States in World War II. In December, 1941, the Federal Reserve announced that it would "use its powers to assure that an ample supply of funds is available at all times for the war effort, and ... exert its influence toward maintaining conditions in the United States Government security market that are satisfactory from the standpoint of the Government's requirements".

These purposes were accomplished. There is no point now in discussing whether too much war finance was provided by money creation and not enough by taxation or borrowing of savings or whether the pegged interest rate pattern was too low, too tilted or generally inadvisable. But there is
point to underlining two facts which tend to be forgotten as the years pass. First, the System's operations resulted in huge purchases of Government securities and consequent huge additions to bank reserves and the money supply. Second, the Government securities market became artificial; normal price risks disappeared and long-term bonds became as liquid as short-term bills, almost becoming interest-bearing cash. The pegged rate structure meant, of course, that the System had no control over the supply of reserves; holders of securities could liquidate them in an assured market at no penalty.

In the five years following the end of World War II the dangerous monetary situation that prevailed at war's end was relieved in large part. Unfortunately, a good share of the relief took the form of letting price increases lift the value of output into better balance with the swollen money supply as the inflation repressed during the war broke out into the open. Fortunately, the Treasury surplus moderated the adjustment but even so it was severe. During the period, monetary policy, with the aid of debt management, gradually and cautiously moved toward a base of greater operating freedom.

March, 1951 saw the Treasury-Federal Reserve Accord which is generally taken to mark the beginning of a flexible monetary policy. Actually much of 1951 should be viewed as an adjustment period during which the pegs were pulled out but support operations continued on a declining scale. Monetary policy itself held mostly constant, partly in keeping with the adjustment period arrangement, partly because economic and credit conditions were propitious for such policy.

By 1952 it was possible for monetary policy to move more flexibly and, in a broad sense, it has been employed flexibly ever since. Generally speaking, I believe that the record since that time has been fairly good with policy shifts from ease to restraint or from restraint to ease being...
reasonably timely, adequate and effective. In my own judgment, the major exception to this statement came as a result of overstaying a policy of ease in the upswing following the 1953-54 recession. Subsequent moves to restraint perhaps could have been more gentle had it not seemed necessary to recapture quickly control that had been let slip for too long.

A few figures will serve to illustrate the flexible character of monetary policy in the nine years, 1952 through 1960. The Open Market Committee held 117 meetings in that period. Broadly speaking, policy changes may be viewed as being of two degrees of strength - major and minor. The major shifts are marked generally by changes in the wording of the directive (more precisely in the b clause of the directive) given by the Open Market Committee to the Account Management. Minor shifts are marked by what I call "shades" in the instructions given the Account Management within the framework of the directive. For example, the directive may call for restraint but the "shaded" instruction may call for meeting seasonal needs. Careful reading of the published policy record indicates these "shades". In the nine years, there were 26 changes in directive and 39 "shades" in the instructions.

In addition to these indications of flexible open market policy, the other tools of credit policy also were used flexibly. There were 7 changes (all reductions) in reserve requirements (including here the steps taken to free vault cash for reserve credit) 7 changes (4 increases and 3 reductions) in margin requirements and 21 changes (13 increases and 8 reductions) in the discount rate in the nine-year period.

A somewhat more detailed examination of monetary policy in 1960 illustrates perhaps more graphically than the mere recital of number of policy changes, what flexible monetary policy means. Despite the spate of very optimistic forecasts about 1960, by early in the year it became
questionable that the American economy would be strongly expansionary. Consequently, as Chairman Martin put it in his testimony before the Joint Economic Committee two months ago, "In the earlier part of 1960, the Federal Reserve System began to lean against the incipient down-wind of what has come increasingly to be classified as the fourth cyclical decline of the postwar era".

From late March through July, open market operations added $1.4 billion, net, to the System portfolio, which purchases offset a $500 million increase of currency in circulation and gold outflow, permitted a reduction of $300 million in member bank borrowing and made possible a $600 million increase in member bank reserves. In early June and in August discount rates were reduced, by 1/2 percentage point each time, thereby lowering the cost of borrowing from the Federal Reserve Banks from 4 to 3 per cent. In August and November, reserve requirement changes, principally affecting vault cash, had the effect of releasing $2 billion in reserve funds. Net purchases of securities in open market operations provided another $800 million reserves in the second half of the year.

For 1960 as a whole member bank reserve positions improved net by more than $1 billion, from net borrowed reserves of more than $400 million in December, 1959 to net free reserves of about $650 million in December, 1960. And this occurred despite the very heavy outflow of gold in the latter half of the year.

Open Market Operating Policy

Before attempting to comment on recent and current monetary policy actions and results, it would be well to discuss the question of open market operating techniques. Ordinarily this is the kind of question that is rarely discussed in talks about credit policy, not because it is secret or mysterious
but because it is highly technical and consequently not particularly interesting to anyone except a few central bankers or central money market people. And yet, few Federal Reserve actions have been so controversial (and I might say, so misunderstood) as the open market operating techniques in effect since 1953.

The continuing operating policy statements referred to were first adopted in March, 1953, and were in effect over most of the period since that time. The statements are three in number and taken altogether cover only 23 typewritten lines. They say, in essence, that System intervention in the Government securities market is solely to effectuate the objectives of monetary and credit policy and is not to support any pattern of prices and yields; that operations shall be confined to short-term securities, except in correction of disorderly markets; that there will be no "swaps" or purchases of "when-issued" securities, maturing issues or comparable maturities during Treasury financings. They also say that they can be changed at any time by Open Market Committee action.

In point of fact they have been changed on several occasions. In November, 1955 purchases on a when-issued basis were authorized. In July, 1956 a massive support operation was undertaken involving when-issued purchases, swaps and transactions in longer securities. In July, 1959 the System portfolio exchanged a maturing issue, partly for short-term, partly for long-term issues. In April, 1960 swaps were authorized to acquire some one-year bills. In October, 1960 the Committee noted that occasions might arise when it would be advisable to conduct operations in short-term certificates, notes and bonds, as well as bills. In February, 1961 transactions in longer securities were authorized.

I do not mean to imply from the above that there was a steady backing away from the sense of the operating policies. Except for the last-
cited which is currently in effect, the authorizations had time limits in
the sense that they were subsequently terminated. I do want to underline,
however, that the operating policies never have been as rigid as some
critics contended.

Now, with this perspective, let me make some observations, most
of which are personal and in no way purport to convey Committee opinion or
even the opinion of any of my colleagues as individuals.

1. The policy statements are subject to criticism on semantic
grounds. Even though the statements carried specific reference that they
were always subject to change, the use of "solely", for example, carried the
connotation of rigidity. Certainly many outside critics came to believe that
the policies were rigid. In retrospect, it probably would have been well to
have softened the language, at least as time went on. At the beginning,
however, the strong desire to get away from pegged markets and artificial
supports seemed to call for strong language.

2. A case can be and has been made that it would be better to have
no formally published rules on operating techniques even though there are
clear statements made that the rules are not rigid. This case rests primarily
on the proposition that any such rules tend to tie the operating hands of the
central bank and that any deviations from the rules tend to look as more im-
portant than they really are.

3. In a very large sense, the whole question is one of techniques
and has nothing to do with the substance of policy. Most open market opera-
tions involve day to day adjustments to offset or accent reserve changes coming
from regular money market factors such as float, Treasury payments and receipts,
and so on. Short-term securities are the natural instruments for such opera-
tions. In the early days of the System a lot of effort was spent in trying to
develop an acceptance market so as to have more short-term money market instruments. The Treasury bill came to fill this need in the United States. In many countries where active short-term markets do not exist, central bankers are trying to develop them so as to have the operating convenience of such a market. I think it a fair statement that most practicing central bankers, including those who would object strongly to the wording of the operating policies, would automatically conduct most open market operations in short-term securities. There are many technical reasons for this approach and none of them is linked very closely to the broad objectives of money and credit policy; they are merely means to achieve such broad objectives.

4. A case can be, and is, made for operating in other than short-term securities at times for the purpose of achieving broad money and credit policy objectives. In essence that case rests on the belief that the central bank should at times take the lead in initiating or inhibiting interest rate changes by direct intervention in that part of the market it wishes to influence.

5. Finally, the point is made that at times the operating situation itself dictates purchases and sales in other than short-term securities. Temporary gluts or shortages of particular issues sometimes can inhibit or delay open market operations and freedom to move in all maturity ranges could ease the technical operating problems at times.

**Current Policy and Prospects**

We come now to the last portion of this talk - current and prospective policy background factors. I referred earlier to what the System did in 1960; let me now try to explain why it did so.

As noted above, by the early part of 1960 it became apparent that the recovery from the third postwar recession was slowing down, but at the same time there were few signs that any significant downturn was in prospect. The
1959 upswing had been strong and the first months of 1960 also showed strength. Driven by heavy inventory accumulation, the GNP in the first quarter continued to show good gains. Bank credit showed about the usual seasonal movements and was well ahead of year earlier figures. Employment was very high. Our export position was good.

Some evidences of weakness and slowdown, however, could be seen or felt. Unemployment hung at uncomfortably high levels. Prospective capital expenditures showed no signs of expansion and the productive capacity of the economy showed no signs of excessive pressure. It seemed likely that inventory accumulation could not be sustained; industrial production failed to show gains and actually registered mild declines. General expectations of price advances appeared to have moderated greatly.

There seemed to be little likelihood that credit demand would push hard against supply. The Treasury was in far better position than it had been; a surplus was being forecast. Interest rates had receded from their peaks. The money supply was showing no signs of expansion and actually was running slightly below year-earlier levels and was down appreciably from mid-1959.

In such a situation there seemed to be little danger in easing monetary policy and as the year advanced that action became more and more definite, as indicated above. But also as the year advanced another factor began to loom increasingly large - the imbalance in our international payments position and an evident and mounting concern abroad about this situation.

There is no need here to discuss this development in detail for the afternoon panel will cover it. The only point I wish to stress is that the picture got steadily worse and foreign confidence steadily lessened.

This development presented the monetary authority with a dilemma. A too easy policy would unduly lower interest rates, particularly short-term
rates, and probably intensify the growing flight of short-term capital. It also might be taken as a sign of an incipient inflationary policy which could cut into our highly favorable trade account balance and heighten concern about the future value of the dollar. At the same time, failure to follow through with adequate monetary ease would inhibit domestic recovery.

Fortunately, the dilemma has proved to be more apparent than real. The downturn in activity proved to be mild, far milder than the other post-war dips, and was mainly an inventory adjustment. Thus a policy of active monetary ease hardly was called for on domestic grounds. But what was called for was a program that was technically difficult to carry out - provision of adequate ease within a framework of competitive world interest rates.

To achieve that objective - inject additional reserves while minimizing pressure in short-term rates - the System used the release of vault cash to supply much of the reserve needs of late 1960. Beginning in October, security purchases of short-term issues other than bills were used. Both steps, of course, avoided the direct impact of System purchases on bill rates. It became increasingly apparent, however, that additional means would have to be sought and in February, 1961, as noted, the System moved aggressively into the longer-term sections of the market. It has continued to operate in those areas ever since.

Some observers have characterized this shift in operating policies as experimental. It is, of course, in the sense that any change in operating techniques where results are uncertain tends to be experimental. The shift, however, was not made out of simple curiosity. It was made to meet a situation that was new to modern central banking in this country.

It is too early yet to tell whether the changed operating policy will be successful. A good many people argue that it cannot work. For example, the last issue of the Morgan-Guaranty Survey carried an article on
interest rate relationships which concluded that short-term and long-term
rates were so powerfully linked that it is difficult, if not impossible,
to force their movements appreciably apart for any prolonged period. The
article also argued that long-term rates have not been any stickier in this
last recession than in former ones.

The Federal Reserve, of course, is very much aware of the technical
difficulties it faces. It recognizes that the costs of seeking a given interest
rate pattern can be enormous, and that those costs become more certain if the
System seeks to go completely counter to market forces. I cited the history
of pegged markets in World War II and thereafter to underline the old adage
that a burned child dreads the fire.

But difficult as the problem is, it should not be made to appear more
difficult. Actually the System is not engaged in an attempt to obtain a given
pattern of rates nor is it necessarily true that it has to get short rates
higher and long rates lower to be successful in its venture. The key point
after all is not rates as such but influences on flows of funds, both domestic
and foreign. And in this context it is possible to claim some success for the
program so far. Speculation against the dollar has moderated, although the
situation still seems delicate. There is some evidence that funds are flowing
somewhat more freely into activities that may help to open domestic expansion.
Growth in the money supply in 1961 has been encouraging.

Actually, even looking at the problem solely from a rate viewpoint,
there are encouraging signs. Short rates have held up remarkably well in the
face of easy money positions and while intermediate and long rates have
registered only slight declines it is perhaps significant that they have not
risen in the light of developing confidence in domestic recovery.
Now, let me turn in conclusion to the foreseeable future. Here I want to emphasize that I speak solely for myself, both as prophet and policy advocate.

It seems to me that three factors argue for continuation of the present policy approach, counting that approach as being both substantive and operating technique. First, it seems highly unlikely that recovery will be so robust as to take up the slack in our productive capacity and our labor force very quickly. If anything, the economy is likely to need as much or more stimulation in the monetary side for some time to come. Second, the banking system is in a less liquid state than it has been at the beginning of other postwar recovery programs and there seems to be relatively little danger in getting it overliquid by continuing to maintain adequate ease. Third, while our international financial position has improved, it can hardly be viewed as completely healthy as yet.

This obviously cannot be taken as a commitment for a long time or even for a short time if the underlying factors change. A booming recovery would make such a policy not only unnecessary but unwise. After all, if a flexible monetary policy has any merit, it is that it changes to meet changing conditions. So I leave you really with no more than the assurance that policy will be flexible and the hope that it will flex in the right way at the right time.