

Mr. Denny

CRITIQUE OF MONETARY POLICY

I. Introduction - Seventh son of a seventh substitute

Subject given as "a critique of monetary policy".

A Dictionary of Contemporary American Usage defines "critique" as "a pretty highfalutin word for a critical examination or review, especially of a literary or artistic work". Technically it does not mean fault finding, but rather the exercise of critical (discrimination or discussion of character and quality) judgment. Certainly this is the sense in which you should regard "critique" as I am forced to use the term.

What we had hoped to present to you today was a "critique" by an outsider rather than by an insider. That would not necessarily mean that an outsider would be more objective, but he almost certainly would have been more refreshing and you would have regarded him as more objective.

My reference to the seventh substitute is reasonably accurate. Without telling you in what order we invited these gentlemen, most of whom have had previous appearances on our workshop programs, let me list our invitees, all of whom had irreconcilable conflicts and could not appear today. They send you their regrets, but theirs are nothing compared to mine.

Heller - Business Advisory Council (command performance)

Shaw and Wallich - out of the country

Samuelson in California, McCracken in New York

Chandler and Ritter otherwise occupied.

That makes seven. I'm the substitute.

What I want to do today is present some perspective on Federal Reserve policy over a relatively long period of time. To do this I am going to work with these charts which you see. Presently I will try to explain the format

of the charts and what I think they show. But before doing that I want to refer back to some points I tried to make in a paper presented to you last year on the objectives of central banking.

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 seem to 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.

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. 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. 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.

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 if we are to 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 withholding of spending from consumption.

Created money or credit, 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 can aid in smoothing the resource allocation process even under an economy operating at capacity. And since a growing economy needs an expanding supply of credit, the supply of credit and the supply of money need to grow also.

Central banking objectives fall into three broad classes - ultimate, intermediate, and proximate. Let us consider first the ultimate objectives of central banking. In one form or another, these have been given in official Federal Reserve publications about as follows: The Federal Reserve System attempts to operate so as to promote or contribute to high employment and production, a rising standard of living, and stable prices. In a paper submitted to the Commission on Money and Credit, the goal of monetary policy was given as "to provide maximum assistance toward promoting long-term growth and containing cyclical swings in economic activity within reasonable bounds, while permitting adjustments which are required to preserve the dynamic character of our economy."

Three comments might be made about these ultimate objectives. First is the fact that monetary policy formulation and execution is a continuous process, and continuous review of developments provides the basis for continuous consideration of policy. The processes and procedures through which policy is executed in the short run are and have to be far more definite and precise than the broad goals but always have to be associated with them.

Second is the question of direct linkage between specific policy action and ultimate economic response. No one can say with certainty that specific central banking action leads to ultimate economic response in precisely such a way or such an amount. The drive shaft between central banking action and ultimate goal is too long and is linked to too many gears of indeterminate speed. Nor can anyone state with precision what would have happened absent the central bank action or with a different action. But here again the indicated direction of central bank action is fairly clear, and the continuous review process makes it possible to change the speed and pressure of such action as the course of developments in the ultimate goals is observed.

Third is the point that the ultimate goals may not always be compatible. In one sense, this is true; in another sense it is completely misleading. The strength of a dynamic and democratic system lies in its ability to make adjustments that permit optimum attainment of the goals of a free society. So to say that the ultimate goals of central banking are not compatible is to state the obvious but without any understanding of our society.

From consideration of ultimate objectives, let us move all the way back to proximate objectives before discussing the intermediate class. These proximate objectives are those most directly controlled or influenced by central banking policy actions. In this group I put nonborrowed reserves, total reserves, and net free reserves (both positive and negative). While many people would disagree, I also put here short-term interest rates and the general level and configuration of the interest rate curve.

We can now move back, more or less halfway toward the ultimate objectives, to consider the intermediate class. These have to do with spending and consumption, saving and investment, and thus include the volume of credit, the liquidity of the banking system and the economy as a whole, and the money supply.

My comments on the intermediate objectives can be quite brief. The linkage between Federal Reserve policy actions, the response of those factors in the proximate objective area, and the secondary response of the factors in the intermediate objective area are seen with reasonable clarity, as I observed earlier. Strictly speaking, Federal Reserve control over intermediate objectives does not exist, but practically Federal Reserve influence does, even though the degree of influence varies with time, place, and circumstance and is not precise nor definite.

While the linkage between proximate and intermediate objectives is not precise and definite, it is far more so than the linkage between intermediate and ultimate. Federal Reserve policy strongly influences total bank deposits and bank loans and investments. Its influence is somewhat less definite on money supply and general liquidity but is apparent. When funds flow into ultimate particular uses, however, they are beyond central bank control - which I believe is as it should be.

Notice the several references to central banking as an art and refer back to the definition of "critique" - "a review of an artistic work". The word thus suits particularly what I propose to do now as we consider the charts.

These charts attempt to present the proximate, intermediate and ultimate objectives of credit policy against the background of policy action. They (the charts) are complex and need explanation of format before explanation of what they show.

Fundamentally what I am attempting to do here is to present something like a 6 dimensional view of credit policy and its results. The colored background of each chart is identical. The three shades of red indicate restrictive

credit policy periods with degree of restriction varying with color intensity. The three shades of green indicate easy policy with degree of ease varying with color intensity. Actually, of course, neither restriction nor ease has only three degrees - in real terms there should be a spectrum of reds and greens. Obviously this cannot be done from a practical standpoint so I have had to be satisfied with the three intensities - which you may think of as light, medium or heavy restraint, or small, moderate or substantial ease.

It is important that you understand how I arrived at these color intensities. And I should begin this part of the explanation by underlining two points about the art of central banking. First, is the fact that credit policy ordinarily shifts gradually; it is a rare occasion when there is an abrupt or drastic change in policy direction. The question that faces the central banker constantly is a simple one although the process in deriving the answer is far from simple. Should policy be easier, tighter, or stay the same? At every open market committee meeting this is the question to answer.

Second, is the fact that the policy record as published provides a clear description of that answer. The Open Market Committee has often been criticized for using ambiguous language in its directives. To a degree that charge is justified simply because words often mean different things to different readers. Certainly any given directive of the FOMC to the desk might be read in several different ways. But a reasonably careful reading of the policy record as a continuum produces reasonably clear indications as to whether policy is designed to tighten, ease, or stay the same relative to the current and immediate past period.

Each policy change over the 1951-62 period is shown on this chart as a shift in color intensity, including as shifts changes from green to red, as well as changes in one color intensity. These policy changes are taken directly from the published policy record, either shown as a change in a directive or

as a (in my terminology) shaded instruction given within the framework of an existing directive.

Let me illustrate. On March 27, 1956, the directive (the pertinent economic clause) read "restrain inflationary developments in the interest of sustainable economic growth". By itself that sounds restrictive and it was. It also sounds highly general and it was. On May 23, 1956, the directive read "restrain inflationary developments in the interest of sustainable economic growth and take into account any deflationary tendencies in the economy". Again this is highly general language but clearly indicates a shift to an easier policy position relative to the former position. Note that I said "easier" and not "easy". This is important. On June 26, with no change in the directive a shaded instruction read " resolve doubts on the side of ease". Once again this is general, but once again it clearly indicates an "easier" policy position than obtained on May 23, although it was not an "easy" position.

Now my point is clear and I think important. Anyone with rudimentary knowledge of economics and monetary affairs can read the published policy record and tell easily from one FOMC meeting to the next whether policy was to be tighter, easier, or stay the same. As noted the record has to be read as a continuum but it should be read that way anyway. And I would bet that all of you in this room would be unanimous in your judgment as to whether policy was to be easier, tighter, or the same as you read the record.

You would not necessarily agree as to whether the basic policy was easy or restrictive, for one man's meat may be another man's poison. My classification of policy as restrictive (red) or easy (green) is based on various factors plus certain subjective judgment. You may not agree with that judgment.

My criteria are: positive or negative free reserves, the direction of movement of free reserves, total reserves, nonborrowed reserves and the bill rate, the absolute level of the bill rate (above or below 2 per cent) and other

than open market policy actions taken by the System - discount rate, reserve requirements, and selective controls. In essence I merely took every month's record when free reserves were positive and gave that month a green checkmark, when free reserves were negative a red checkmark. When free reserves, total reserves and nonborrowed reserves were rising they got green checks, when they were falling they got red checks. When the bill rate was above two per cent for the month it got a red check, below two per cent it got green. When it was rising it got red, falling it got green. An advance in discount rate was red, a drop was green and so on.

I arranged these color checks in rows by months chronologically and inspected them. Obviously when all or most signs were red or green there was no problem; when there was a mixture of reds and greens for a month I went partly by majority but partly by direction of reserve and bill rate change (free, nonborrowed or total) rather than by absolute level of free reserves or bills. The results are as shown.

Now I hope I will not be charged with circular reasoning by using this procedure. Again let me make clear that every shift in color intensity or from red to green is given solely on the basis of the policy record - either the directive or a shaded instruction which indicates "tighter", "easier", or "no change", but not "tight" or "easy". Only the basic color is derived from the criteria cited plus the judgment factor. And while it is true that this methodology generally shows free reserves negative or falling, a bill rate above 2 per cent or rising, total and nonborrowed reserves falling and upward movement of discount rate or reserve requirements or margin requirements, etc., during a red colored period and the reverse during a green colored period, I am not using those facts to prove that policy yields results beyond what everybody knows - that the proximate goals are directly affected by policy.

The record of the intermediate and ultimate goals is, insofar as my colors are concerned, independent.

One final word about the color scheme. In the early period, 1951, the chart is white. This was the period of neutrality following the Accord and there really were no policy shifts. In a sense this period might be colored green since all the criteria show green, except reserve requirements, but I have left it white just to point up the neutrality under the first year following the Accord. Also, as is well known, there are periods when the System attempts to hold an "even keel" when a Treasury financing is in progress. This is really a policy of no change but for a special reason other than credit policy. Probably it would be well to show such periods also as white but I thought it more useful just to keep the current color going so as to avoid further confusion.

Now, hoping that the principle of chart background color is adequately explained, let us pass on to the chart lines.

Chart I - Total reserves - seasonally adjusted and adjusted
for changes in reserve requirements.

(This latter adjustment means that \$1 in reserves supports the same amount of deposits at all times.)

nonborrowed reserves

Free reserves

discount rate - N.Y.

3-month bill rate

Long bond rate (as published in the Bulletin)

These are the proximate objectives and their movement shows the direct impact of policy - a fact well known.

Chart II liquid assets - seasonally adjusted
currency, demand and time deposits - seasonally adjusted
loans and investments - bank credit
gold stock - see right hand scale

These are intermediate goals.

Two points important to note - policy really has not aimed at direct curtailment but rather changes in rate of growth. Credit, money and liquidity are affected by policy - at any rate the slopes of the curves change as policy moves from restrictive to easy and back.

Chart III These are ultimate goals and in a sense also guides to policy. All series, except prices, are seasonally adjusted. I think credit policy's concern with unemployment is amply demonstrated. I think also that these indicate that policy's timing has been, while not perfect, extremely good on the whole. And it must be noted that never are the economic data plotted available at the time of policy decision which emphasizes the goodness of timing. Finally, I think the response of these goals to policy is quite striking.