MONETARY POLICY

Remarks by

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Preliminary to a discussion of the formulation of monetary policy by the Federal Reserve System should be an inquiry in the authority of the System to act. This is not the academic exercise it might appear to be. Patterns of use of economic tools by an instrument of the body politic are shaped by the legal restraints imposed upon their use. An explanation of how must be preceded by the inquiry of why. I do not purpose to belabor this point, but I would like to give you a few benchmarks.

Monetary policy is an element of the power to control money, and sovereign governments understandably have always regarded the right to control money as a prerogative to be guarded above all others. In the exercise of this prerogative they have brooked little interference from the courts; not that there has been much, for courts generally have tended to support the sovereign.

One of the strongest statements relating to the monetary power in western judicial tradition is the Mixed Moneys case of 1604 decided in England. Queen Elizabeth, to help finance a war, struck off a debased coinage for circulation in Ireland only. A creditor refused to accept the coinage. The court, in requiring the creditor to accept the debased coin, said:

> ". . . as the king by his prerogative may make money of what matter and form he pleases and establish the standard of it, so he may change his money in substance and impression, and enhance or debase the value of it or entirely decry and annul it. "

To the great discomfiture of conservatives, this has been woven into the judicial construction of Article I, Section 8, Clause 5 of our Constitution which says simply:

> "The Congress shall have Power . . . To Coin Money, regulate the Value thereof, and of foreign Coin

On these words Congress has created the whole edifice of national banking, the FDIC and the Federal Reserve System. Obviously, this has not been done without challenge.

This clause has been before Supreme Court a number of times, but perhaps the water sheds of interpretation are McCulloch vs. Maryland (17 US 316, 413), the greenback cases of the Civil War (75 US 603, 79 US 457, 110 US 421), Ling Su Fan vs. the United States (218 US 302), and finally the Gold Clause cases (294 US 240, 294 US 317, 294 US 330). A quote from each will illustrate the moves by the Supreme Court toward its acknowledgment that the exercises of this power by Congress are not subject to judicial review.

McCulloch vs. Maryland involved the second bank of the United States and was an attempt by the State of Maryland to tax the bank notes issued by that bank. In 1819, Justice Marshall ruled against the State of Maryland and said:

> ". . . Let the end be legitimate, let it be within the scope of the constitution, and all means are appropriate, which are plainly adapted to that end, which are not prohibited, but consist with the letter and spirit of the Constitution, . . ."

The circumstances of the greenback cases were not dissimilar from the Mixed Moneys case of 1604. After all, the United States was attempting to finance the Civil War, and faced with its enormous costs (for that day, anyway) issued money of dubious value in the eyes of some.

There are three cases; the first being overruled by the second, and the third enlarging the principles of the second. In the last of these, the court in 1884 said:

> ". . . the question, whether at any particular time, in war or peace, the exigency is such, by reason of unusual and pressing demands on the resources of the government, or of the inadequacy of the supply of gold and silver coin to furnish the currency needed for the uses of government and of the people, . . . it

is . . . wise and expedient to resort to this means, is a political question, to be determined by congress. . . ."

The third case, decided in 1910, involved an enterprising Chinese merchant who was trying to ship silver coin from the Phillipines to the Mainland at a time when this coin had a bullion value in excess of its monetary value, for which reason its export was expressly prohibited. Mr. Su Fan argues that he was being deprived of his property without compensation and without due process of law; that is, he was not being allowed to do with his money as he wished. The court denied his claim with this language:

> "Conceding the title of the owner of such coins, yet there is attached to such ownership those limitations which public policy may require by reason of their quality as a legal tender and as a medium of exchange. . . . They bear, therefore, the impress of sovereign power which fixes value and authorizes their use in exchange. . . .
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> "However unwise a law may be, aimed at the exportation of such coins . . . there can be no serious doubt that the power to coin money includes the power to prevent its outflow from the country of its origin. . . ."

The full circle, that is, the final positive affirmation in this country of the spirit of the Mixed Moneys case, came in the Gold Clause cases which as you may recall arose out of a joint resolution of Congress forbidding the circulation of monetary gold and denouncing all clauses in contracts requiring payment in gold as "against public policy". The court drew attention to the constitutional authority of the Congress with this language:

> ". . . The contention that these gold clauses are valid contracts and cannot be struck down proceeds upon the assumption that private parties . . . may make and enforce contracts which may limit that authority. . . . We think that it is clearly shown that these clauses interfere with the exertion of the power granted to the Congress, . . ."

One final quote, this one attributed to Justice Jackson:

> "Two of the greatest powers possessed by the political branches, which seem to me the disaster potentials in our system, are utterly beyond judicial reach. These are the war power and the money, taxing and spending power, which is the power of inflation. The improvident use of these powers can destroy the conditions for the existence of liberty, because either can set up great currents of strife within the population which might carry constitutional forms and limitations before them . . .
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> "No protection against these catastrophic courses can be expected from the judiciary. The people must guard against these dangers at the polls."

Hail, Wright Patman. So by the repeated decision of the Supreme Court, the Federal Reserve System like the other extensions of the monetary power, exists as an exclusive creature of Congress. Passionate supporters of the System don't really like to think of it that way, preferring to regard the System as having emerged full grown from the mind of God. On examination though, I think even these supporters of the System have few complaints. The Act reasonably sketches basic authority, which has proven remarkably elastic over the years. Many of the accepted elements of the System today have evolved out of a mixture of serendipity and pragmatism, and nowhere is this more apparent than in the evolution of monetary policy operations by the System.

Of the evolutionary changes, perhaps the most important to our discussion here today has been the basic shift in operating philosophy from a defensive role to the dynamic one, a change accomplished without an overt change in the law. And to the two basic tools, the discount rate and the reserve requirement, we have added at least three more. These are open market operations, Regulation Q, and jawbone. While the nature of these tools has been touched upon by former speakers, a word about the role of each might be useful.

The discount rate is used primarily as a signal. Robert Roosa, one of the most skillful money managers this country has ever produced, in discussing the structure of the money market and its rates said "the keystone of the entire structure is the discount rate of the Federal Reserve Banks." Its monetary use other than as a signal rate has varied over the life of the System. In recent years, direct advances to member banks have been made under ground rules set out in Regulation A. Generally, a bank cannot borrow unless they show an unusual run-off of deposits or some emergency condition in the economy of their area. In this ad hoc context its influence on the monetary climate has been secondary, although the September 1 letter of last year might be regarded by some as an attempt to use it as a primary tool.

Reserve requirements are altered only occasionally. While there is divided judgment as to the level of reserves required for the historic purpose of security, the consensus is that this requirement is much lower than the present levels. How high reserves should be as an instrument of monetary policy is a matter of even less agreement. It is a tool used very sparingly in the country although many other countries use it frequently and well.

Regulation Q sets the limits a member bank can pay on time money. It came into particular prominence last year because of its effect on the allocation process of the money supply among the various financial intermediaries. It proved itself as a potent tool indeed.

Jawbone refers to the attempts by officials of the System to indicate economic direction through public speeches, monographs, and the whole range of information that comes from the System. It is an important monetary tool whether applied by a president in conversation with a member banker about the use of the discount window, or the chairman in a talk on the balance of payments.

Of all the tools, the one that is the envy of the free world and perhaps most fascinating to the business and financial community is the open market operation. How does it work? At the heart is the open market committee. This is worth spending a minute or so on, because this is the policy body of the System. Where I use the word "member," I am not referring to the legally constituted committee, which consists of five voting presidents plus the governors, but the full complement of the participants, which includes the other seven presidents.

As preparation for the meetings, at three to four week intervals, members are given a full range of economic information available in the United States, not only relating to this country but to the world, some of which comes daily, some weekly, and some in special pre-meeting statements. In the last group are these important pieces: the white book prepared by the research staff of the Minneapolis Bank which covers conditions in the district and attempts to relate them to national developments, the green book which is prepared by the staff of the Board of Governors and is the basic document on the national scene. In addition, we receive what is known as the blue book which deals with banks and reserve movements. This is a particularly important book, for it is in this that the Board staff attempts to nudge the unwilling and sometimes unwary into appropriate positions. Seriously, though, the information is superb and as we enter the meeting room if we are not adequately briefed with background information it has been nobody's fault but our own.

The meeting is opened with a series of staff reports: open market operations, foreign exchange operations, developments in the balance of payments, developments in the financial sector, and general trends in the economy. Each governor and each president then comments briefly. This is all preliminary to a discussion of a directive to be used as guidance by the manager of the desk. While the directive is couched in general terms, it is usually the result of both substantive and semantic dialogue that can become quite heated and revealing of attitudes. It is this dialogue that establishes the flavor of the directive that the managers of the open market desk and the foreign desk take back with them to New York where they must each day attempt to establish a monetary posture for the United States which will be within the general framework of the directive but still responsive to the daily changes that occur between meetings.

The desk manager has four functions: (1) collecting information; (2) conducting of a trading operation, buying and selling securities to influence the reserve position in member banks; (3) performing ancillary service, such as bookkeeping for all of the banks and serving as agents for foreign governments; and finally (4) participating in the policy decision of each day.

The interplay between the dynamic role and defensive role of the system is illustrated in this process. Let us assume the general objective of the committee is always the achievement of a monetary environment in which the level of economic growth is consistent with reasonable price stability and full employment. Let us also assume that at a particular time this requires a general directive of easing. Yet each day occur aberrations in the money market which may accelerate the movement towards easing and therefore require curbing to prevent an excessive rate of bank expansion; or conversely, may require a greater than normal injection of reserves in order to counter an acceleration in the opposite direction. Peace feelers from Hanoi, messages from the White House, public announcements from major industrial figures, all of these play their part. So to adapt policy each day to these new conditions a conference call is arranged among the desk, the Board, and one of the voting presidents. At this time the condition of the market is discussed and the recommendation by the desk that day originating with the manager is approved or disapproved.

How were these tools used last year? These were the high spots: The discount rate was increased in December of 1965 as a signal to the market that the System believed the economy was overheating. This freed the interest structure to move up and dampen demand. At the same time Regulation Q was increased permitting member banks to pay higher interest rates on time money and thereby to compete with other financial institutions for time money. In the summer and in the fall selective changes in Regulation Q were made to curb excessive competition among financial institutions. For the same reason, reserve rates applicable to time money in certain categories were changed in late summer.

There were a number of jawbone exercises. The discount letter of September 1, the flood of speeches and critiques on monetary policy, the level of economy, bank lending practices and so on were obvious examples.

And, of course, the open market desk walked a tightrope through the period, attempting to move each day to advance the general directive towards tightening, although on many days it was essential to take counter measures to minimize the churning in the markets and to prevent too rapid an increase in rates. This led to the paradoxical situation last spring when the money supply continued to increase even though there was an avowed move towards tightening. Critics of this pattern might well speculate what the rate structure would have been, if the System had been less cautious in its tightening.

How did banks react? These charts illustrate the attempt by two major district banks to respond to tight money in the face of intense pressure from their customers. The green represents Fed Funds. The blue represents funds borrowed from us. You will notice the interplay between the two as we tightened our loan policy. Also significant is the variation in the pattern of the two banks.

These charts are district wide, and include all the larger members. They reflect our lending activities only. Note April 1966 when the program really started to pinch. Loan demand was still going up but there was no offsetting growth in deposits. As was illustrated in the charts for the two individual banks, we tightened our loan policy. By September all reserve city banks were out of debt to us. Only a few country banks were in debt to us. But these other banks were, on their own initiative, adjusting to tight money. They were curtailing loans. The turning point probably occurred sometime in September, and once the point was reached, the change came rapidly. In November, monetary policy relaxed in which position we continue today.

I think, as history will tell the story, 1966 demonstrated this lesson: the trustees of the nation's monetary system have an exceedingly delicate task to perform. Some of the tools can be used superbly on a daily basis, or to give fairly short-term nudges--such as open market operations. Other tools are more blunt and direct in their specific effects on particular sectors of the economy. These have to be used with consummate care in a context that includes complimentary fiscal action, for to rely on the monetary tools primarily to alter national economic trends as abruptly as had to be done last year is risky indeed. For monetary policy is an indirect instrument of national economic policy. Generally its point of initial impact is the commercial banking system. How business levels are ultimately affected is the result of private decisions of many United States bankers, who in turn are constantly engaged in competition among themselves and in a larger sense with the other elements of the money markets. This indirect linkage between monetary policy as determined by the Federal Reserve System and the many sectors of the economy who collectively determine our economic health is not always predictable. And, quite obviously, the impact of changes in monetary policy is far from uniform. For example, S & L's were unhappy losers in the competition for funds last year. Ultimately though, in the seesaw of savings flows last year, banks took their losses when market rates rose above Regulation Q rates. This phenomenon, referred to as disintermediation, put the investor of funds directly in the money markets, by-passing banks and the other conventional intermediaries.

And there were other dislocations. Residential construction was crippled. Life insurance companies were called upon for policy loans in an unprecedented volume. It did produce some benefit in terms of our balance of payments. We brought back some $2 billion from the Eurodollar markets.

All in all, I think the exercise succeeded. The runaway was forced back into the stall. But I don't think we will ever be able to do it again. It might be questioned that the monetary framework, as we know it, would survive that kind of a process again. Monetary policy, as I have said before, is a fragile, delicate instrument and it is a creature of Congress.

Congress was remarkably patient. But the pressures to "curb the Fed" were great. Faced with similar economic pressures--and a similar response by the Fed in the absence of appropriate fiscal action and less success than we had this time, the structure of the Fed might well be altered by Congress.