

Remarks by

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I am grateful to the Savings League of Minnesota and its executive vice president, Mr. Welch, for the invitation to come here this noon. For some time now, I have been wanting to talk about the Federal Reserve--or, if you prefer, to explain its policy. But to explain anything as complicated as monetary policy, other than in glittering generalities, one needs a knowledgeable audience; and thanks to the Savings League and Mr. Welch, that is exactly what I have here before me--a knowledgeable audience.

Of late, the Federal Reserve has come in for a good deal of criticism--more than its share, I should say. I am not complaining. Whatever it does, the Federal Reserve must expect criticism. Also, criticism, however mistaken, is reassuring. No one bothers to criticize an institution which can do nothing, whether for good or bad. As I have said, it is reassuring, or comforting, to know that there are individuals who believe that it matters what the Federal Reserve does. I do hope, though, that its critics have not come to think of the System as all-powerful. And this seems to have been the case. Implicit in the criticism of such critics as Edward Dale of the New York Times who entitled a column about the Fed "Laughing at the Fed", or Carter Golembe who said in a recent news letter "...but the real problem with the Federal Reserve is...that Federal Reserve policy for the past three years has been almost consistently wrong", is an assumption that monetary policy, or to put it more specifically, the state of the art of economics, can right all wrongs. Quite simply, it cannot. Even less is it infallible. It is a judgmental process and men can differ--and err--in matters of judgment. The System has made errors of judgment over its history, and no matter how reasoned its position may have been at the time, the inflexible logic of how the game came out cannot be refuted.

Yet much of the recent criticism of the Federal Reserve is, I believe, mistaken; and if the System must expect to be criticized, it has an obligation as a public institution to attempt to explain itself. Neither Mr. Dale nor Mr. Golembe are casual critics; to the contrary, they are serious, thoughtful men whose intentions are never frivolous. As a quondam student of the American scene I respect them. Should they-- and the interested public--lose confidence, the Fed will not long remain effective.

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I should like this noon to take up two specific criticisms of the Federal Reserve: The first is that it has not prevented inflation. For some critics, happily few in number, the charge is that the System is indifferent to inflation. The second criticism is that the Federal Reserve operates in the wrong way, and in particular that it does not pay sufficient attention to the money supply. Some critics would have the Federal Reserve concentrate exclusively on controlling the money supply, paying no attention at all to the behavior of, for example, interest rates, or more generally to conditions in credit markets. A few critics would have the Federal Reserve abandon what is called discretionary monetary policy. Instead of responding as it thinks best to a changing economy, as it has throughout its long history, it would simply increase the money supply at a constant rate month-after-month and year-after-year. If it were to heed the call of the critics, it would become oblivious to the world around it.

Turning to the first criticism, let me note first of all (as if I had to remind you) that we have had considerable inflation; over the past three years, the trend of prices has been sharply up.

But this is not to say that the Federal Reserve has failed--or that it has become indifferent to inflation, that most capricious and unjust of taxes.

It is ironic that the System should now be charged with having become indifferent to inflation. For a long time, the charge was that it worried only about price stability, and not at all about unemployment. But it is easily demonstrated that the Federal Reserve has not become indifferent to inflation. It is enough to recall that in December 1965 it increased discount rates, and in so doing incurred the wrath of the administration in Washington. It knew it would, and still it shifted to a more restrictive monetary policy. Why? Because even at the risk of a clash with the administration, it wanted to do what it could to curb inflationary pressures.

Let me repeat what I just said: that it wanted to do what it could. I want to emphasize that phrase "do what it could." What we must all keep in mind is that the Federal Reserve is not all-powerful; it cannot, by itself, ensure stable prices, or curb inflationary pressures. There is no danger, I would add, of System officials forgetting this; being constantly reminded in one way or another, they are ever mindful of the limited effectiveness of monetary policy.

Perhaps the most important explanation for the limited effectiveness of monetary policy is that the System, unlike its critics, cannot be singleminded about inflation. It amply demonstrated its concern about inflation in December 1965, and will again, I assure you, in the months immediately ahead. But it has other concerns; and at various times in the past, one or another of these concerns has constrained it.

To illustrate, I need but recall the first half of 1966, over which period the rate of growth of the money supply increased. For some, this is evidence enough that the Federal Reserve had given up fighting inflation, or had become blind to what it was doing. The first half of 1966 was, however, a period of rapidly increasing interest rates; and to be frank, during the period the Federal Reserve was worried that a few thrift institutions--not anything like all, mind you, but a few thrift institutions--might fail if interest rates were allowed to go higher still. It is no accident that in September of 1966 a bill was passed which limited competition among banks and thrift institutions.

So through early 1966 the Federal Reserve had to resist the obvious temptation to drastically curb the growth of the money supply and bank credit. This would have meant still higher interest rates, and very likely the failure of a few thrift institutions, which could easily have seriously undermined confidence in the entire U.S. financial system.

It is not that the System had become indifferent to inflation, or blind to what it was doing; it is rather that it could not be single minded. In 1966 it could not ignore the threat to confidence in the financial system which it faced. Critics without responsibility may ignore the threat, particularly in retrospect, but in the immediacy of events the System could not.

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I would be less than candid if I did not admit that over a good part of the second half of 1968 System policy was mistaken; it was less restrictive than it should have been. It is easy to get an exaggerated impression of how much the System eased up. In fact, it eased up very little. The discount rate change of August 1968 was not great; rates were lowered one-quarter of one percent.

This may be special pleading under the heading of the "galled jade winces", for the Minneapolis bank led the System, but when did a change of one-quarter of one percent signal a "vast change in monetary policy", as one respected editor categorized it? It was not even half vast by historical standards, and was in fact precipitated by a marked change in market expectations which posed technical operating problems for the System. I freely, though painfully, admit error. But the rates of growth of bank credit and money did not accelerate all that much. It was a change in expectations more than a change in System policy which explains the fall decline in interest rates. Still, the System might well have resisted the decline, as is clear in retrospect.

But System officials, along with nearly everyone else, were wrong in expecting fiscal restraint to take effect quickly. They perhaps underestimated the strength of inflationary pressures, or just how anxious the public, conscious of rising prices, was to spend on goods and services. And having been over-optimistic in its estimate of when fiscal restraint would take hold, it delayed too long before imposing further monetary restraint. This, however, is the explanation for its having delayed--to repeat, an overly optimistic estimate of when fiscal restraint would take hold. Most assuredly, the explanation is not an indifference to inflation, or a lack of awareness of what it was doing.

I said a moment ago that in 1968 the System delayed imposing further monetary restraint. The implication is that after awhile it did impose the needed restraint. This is right, although from what critics have been saying you might not think so. As I am sure you are aware, interest rates are considerably higher now than they were in early December. The money supply, however, defined, has been increasing less rapidly than it was; and the same can be said of bank credit. It is simply that critics have not been paying sufficient attention to current monetary developments.

It would be easy, of course, to be swayed by the critics who have complained about a lack of monetary restraint--and, in a manner of speaking, to give the economy a fatal knock on the head (just to get its attention, you understand). But this the Federal Reserve cannot do, and precisely because curbing inflationary pressures is not its only objective. There are other objectives, of which not the least is maintaining reasonably full employment; with all the social problems which beset this country, this is not an objective it can ignore. To be sure, curbing inflationary pressures will likely involve an increase in the unemployment rate. But there is a difference between knocking the economy on the head, or precipitating a severe recession, and gradually curbing inflationary pressures. With a recession there would be a sharp increase in the unemployment rate; but if the Federal Reserve seeks a gradual waning of inflationary pressures, the increase in the unemployment rate will be smaller.

I indicated a few moments ago that the Federal Reserve misjudged how quickly fiscal restraint would take hold. I do not want, however, to be misunderstood. It is not that imposition of the tax surcharge, or the cutback in government spending, is going to be without effect. Economic statistics for the past couple of months suggest that the pace of economic advance is slowing. And monetary restraint will force a further slowing, and thereby a waning of inflationary pressures. When the economic slowdown becomes more apparent, there will emerge critics who will insist on less monetary restraint, or that the Federal Reserve ease up. But the System will also have to resist these critics. For three years now, the price level has been increasing sharply; it will therefore require a considerable period of monetary restraint, and hopefully fiscal restraint as well, to restore reasonable price stability.

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Let me turn now to the second of the recent criticisms of the Federal Reserve. Put briefly, this criticism is that it operates in the wrong way. Allegedly, the Federal Reserve pays too little attention to the money supply. And in administering monetary policy, it is guided by its judgment of what the present and future require; but to avoid mistakes of judgment, it should be guided by inflexible rule, which would result in a steadily increasing money supply.

Unfortunately, there is not time enough for me to take up this criticism, which is really in two parts, in great detail. I shall have to leave doing so until another time. But I can very briefly indicate why I believe the criticism is mistaken.

For one thing, the Federal Reserve does pay attention to the money supply. As you know, the Federal Reserve Bank of New York conducts the System's open market operations in behalf of the Federal Open Market Committee, which is made up of all the Reserve Bank presidents and the Governors of the Federal Reserve System and which determines open market policy. Every month this committee meets and at the end of its meeting gives its instructions to the New York Bank. The instructions, however, are never categorical; the Bank is told to modify its open market operations, depending on how rapidly the money supply, broadly defined, appears to be increasing. Clearly, then, it cannot truthfully be said that the Federal Reserve pays no attention to the money supply.

It does not, however, pay attention only to the money supply, which is what some of its critics would have it do. In short, it is not as singleminded as some of the critics; it cannot afford to be. Interest rates matter, they influence the growth of banks and thrift institutions; and beyond that, international capital flows and the U.S. balance on international account.

But there is a rough relationship anyway between the money supply and interest rates. Over the short run, the relationship is inverse; the greater the rate of growth of the money stock, the lower are interest rates. Some of the time therefore the rate of growth of the money supply has to be fixed with reference to what average level of interest rates is appropriate.

This explains why the Federal Reserve cannot simply increase the money supply at a steady rate; whatever the steady rate of growth is, it may imply an average level of interest rates which is inconsistent with, say, the U.S. balance of payments objective. Imagine U.S. short-term interest rates at, for example, two or three percent, and foreign short-term rates averaging five or six percent; the U.S. might not be able to stand the implied loss of funds to other countries, or the implied balance of payments deficit.

Actually, there is no need for the Federal Reserve to adopt an inflexible monetary rule. The critics have said (I have the redoubtable Professor Friedman in mind) that if the System were bound by a rule, it would not be able to make disastrous mistakes. In the 1930's it made such a mistake; it allowed banks to fail, and there was a disastrous decrease in the money supply. But as the critics themselves have admitted (again, I have Professor Friedman in mind), the Federal Reserve has not made a major mistake since 1933--or, more to the point, the postwar period. So why bind the Federal Reserve to avoid what on its own it has avoided--namely, a major mistake of judgment.

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Anyone who defends an institution against its critics runs a risk; he may give the impression that the institution he defends is, in his judgment, perfect. Now, then, at the end of my remarks, let me be

quite clear that I do not believe the Federal Reserve is perfect. Its history is marked by mistakes of judgment; one has to go back but a few months to find one, which, however, was happily not of great consequence. But if the Federal Reserve is not perfect, neither is it as misguided as some of its critics would have you believe. Would that the Federal Reserve's critics were as willing to learn as, through its history, it has been.

We would do well, I believe, to recognize that criticisms of the Federal Reserve have appeal. The doctrine of the monetarists, which is how we have come to refer to some System critics, is simple; and simplistic doctrine has at least limited appeal. But we must remember that simplistic doctrines do not always serve well in a complex world.