4

REMARKS OF ALLAN SPROUL, PRESIDENT
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CENTRAL BANKS AND MONEY MARKETS

The last time I appeared before the New Jersey Bankers Association was at your mid-year Trust and Banking Conference in December 1946. I made what was probably an overlong speech on Monetary Management and Credit Control. It was an after dinner talk, and even now I seem to remember some glazed eyes in the audience before I finished. To one less addicted to preaching the gospel than I am, that experience might have suggested a more lively topic for this occasion. I am going to risk talking on the same general theme, however, hoping that it may seem less dull in the afternoon than it did in the evening.

In any case, I must assume that when you ask me to speak you want to hear about some aspect of the work of the Federal Reserve System, and I continue to believe that you as bankers, and as citizens, ought to know more about what the System is doing. It is always sobering to me to realize how much economic power has been put into the hands of those who manage the Federal Reserve System and how little attention, proportionately, is paid to the quality of those who control the System's operations and to the way in which they perform their duties and discharge their responsibilities. The fact that the System has done its job as well as it has, without abuse or misuse of power, is a tribute to the continuing high calibre of men who, inconspicuously, have made staff careers within the System, and to individuals who, from time to time, on the Board of Governors and the directorates of the Federal Reserve Banks, have been willing to devote themselves to the policy aspects of a worthwhile public service.

Stimulated by this righteous appreciation of my own brotherhood, I would like to say something, first, on recent credit policy and, second, on certain particular aspects of our recent open market operations.

As you all know, for the past nine or ten months we have been in a period of declining economic activity, call it what you will. How has the Federal Reserve System reacted to this development? Well, its reaction really began in the preceding period of "boom" when, during 1952 and the early months of 1953, it applied monetary brakes to a situation which seemed to be calling more credit into use than was required to maintain our economic balance. That sort of situation, if unchecked, breeds speculation and may spell inflation and erosion of the purchasing power of the dollar. And it may also spell subsequent deflation; perhaps severe deflation with its accompaniment of widespread human suffering. Helping to prevent the formation of a speculative bubble on top of a boom is the most effective action which the Federal Reserve System can take to make cumulative deflation less likely. We have to try to see to it that, so far as monetary policy is concerned, periods of economic advance are not distorted by speculative excesses which lead to sharp and disorderly declines.

Once the turn comes, however, or even when it seems to be coming, an alert central banking system should relax whatever pressure it has put on the reserve position of the commercial banks. Otherwise they may be forced or, at least, influenced to restrict credit and to put pressure on borrowers to repay outstanding loans. In fact it is largely true, I think, that if left to itself the credit mechanism may tend to aggravate an economic downturn, as credit risks rise and lenders become more cautious. The objective of monetary management, in the first phase of a directional change in policy, is to try to prevent this from happening.

If a decline in economic activity persists, of course, the duty of the Federal Reserve System goes well beyond checking the possible perverse action of the private credit mechanism. The System can then see to it that a monetary climate favorable to credit expansion and capital expenditures is created. It can see to it that commercial banks are amply supplied with reserves, and have ample assurance of the continuing availability of reserves at low cost. It can see to it that the cost of borrowed capital turns in favor of the borrower. Its policy becomes an affirmative aggressive policy which helps to remove deterrents to expenditure by individuals, by business, and by State and local governments.

The financial needs of the national Government must also be considered in such circumstances, and not in a narrow or political sense. Government deficits are likely to develop or increase in a period of economic decline, either through reduced tax collections or increased expenditures, or both. New money will have to be borrowed, and some of it will have to be and ought to be borrowed from the banks. Unless the banks are provided with ample reserve funds, however, the Treasury will be unable to do its necessitous financing without causing some lessening of the availability of credit to private borrowers. The banks have to be able to meet both private and public needs with some degree of assurance and comfort, or the stimulating effect of Government spending of money borrowed from banks will be offset by the restraint which Government borrowing has placed on private credit.

The course of Federal Reserve policy during the past year has been generally consistent with these objectives. The restrictive policy of 1952, and the early months of 1953, was reversed in May 1953, when it was decided that inflationary pressures were no longer dominant in our economy, and when evidence of constriction in the capital and mortgage markets made some reversal of policy a monetary necessity. As evidences of economic decline developed, we took the offensive and supplied substantial amounts of reserves to the banking system somewhat in advance of actual need. And right up to the present moment there has been assurance and re-assurance, through open market operations and reductions in the discount rate, that reserve funds are and will be readily and cheaply available so long as the present economic situation persists.

As a consequence, whatever tight spots there may have been in the money and capital markets have been eased or eliminated, first by our action and later by forces within the market. Bank credit, corporate borrowing, mortgage borrowing, consumer credit, and borrowing by State and local authorities (if rightly priced) have all been freed of the restraints of the earlier period. Truly, as is necessary in a period of economic decline, monetary policy has gotten out of the way of production, distribution, and spending. It has helped to clear the way for economic recovery.

There are those, of course, many of whom usually sit facing backward - it is slightly easier to see where you have been than where you are going - who criticize our intervention, and particularly the steps we took to check credit expansion in the boom period which preceded the present decline. Their thesis seems to be that monetary action taken to check a boom will bring on a decline which cannot then be checked. That is tantamount to saying you do not want a central bank, although surprisingly these critics are often the same people who favor a variety of Government intervention in economic affairs. I would not claim for one instant that our recent performance has been perfect, that it has been without mistakes. But I do claim that within the permissible range of human error, in a field where there are no absolutely fixed points of reference, monetary policy has made its contribution to the protection of income, employment, and the stability of purchasing power of the dollar, in this period of transition from a highly stimulated war economy to a predominantly peace economy.

The overtime economy, the hyper-activity economy of late 1950 to early 1953, did not bear the seeds of sustained prosperity. It bred the need for the economic readjustment we are now going through. Monetary action can't stop a decline in economic activity during such a period of transition, but it can help substantially to keep the decline from over-reaching the real needs of economic readjustment. That, I think, it has helped to do in this instance. If the economy now, or within the year, begins again to realize its potential for growth, without too many injections of short-lived artificial stimulants, this country will have given the world a heartening example of improved economic stability.

Turning from the general outlines of recent central banking performance to particular details of policy execution, I now want to touch on certain aspects of our open market operations during this period. The skeleton of the discussion of these operations has been published in the record of policy actions of the Federal Open Market Committee which is printed with the Annual Report of the Board of Governors of the Federal Reserve System for 1953, and there is some further discussion in the body of the Board's report. So far as I am aware, very little attention has been paid to this published record. Maybe that is as it should be. Maybe our arguments over form and method were too fine-spun to interest anyone but a central bank theologian. Maybe I should let the subject rest in peace, since in the debate I was one of a small and diminishing minority. And maybe the majority was right. As I said in the beginning, however, I think it is important that there be a wider and better understanding of how the Federal Reserve System performs its functions, and I believe that our present techniques of open market operation are a matter of importance and, therefore, deserve more banking and public scrutiny than they have had.

Let me emphasize immediately that there has been no division of opinion among us as to the general aims and lines of credit policy during this period. And let me also say that, given the general policies we unanimously adopted, our differences as to techniques may not currently be of first importance. My concern is not with degrees of present importance. My concern is that there be wider knowledge and understanding of what we are doing, and that it be critically examined. We are then less likely to dig a groove which becomes a rut, making change difficult if different circumstances make change more important.

The main questions at issue, I think, are

1. Should Federal Reserve purchases and sales of Government securities be made solely for the purpose of providing or absorbing bank reserves? Among other things, this excludes offsetting purchases and sales (even swaps) of securities which have the effect of altering the maturity pattern of the System's portfolio, and excludes purchases (and sales) which might be made at times of Treasury financing in direct furtherance of an integrated program of debt management and credit policy.

2. Should Federal Reserve open market operations be confined to short term securities? In practice, as is shown by the published statistics, this has meant confining operations to transactions in Treasury bills.

It has been my view that a central banking system does not discharge its responsibilities and complete its functions in the best possible manner, in our present day economy, by directing its open market operations solely toward putting reserves into or taking reserves out of the commercial banking system. I believe that the central banking system should retain freedom of action to assist or promote, directly and under appropriate circumstances, changes in the availability and cost of funds throughout the money and capital markets, and freedom of action to assist, directly and under appropriate circumstances, desirable debt management operations of the Treasury.

Those who espouse the opposite and presently prevailing view will have little or none of this. They have emphasized the view that the Federal Open Market Committee, except in the extraordinary circumstance of a "disorderly market", should limit its operations in Government securities solely to operations for the purpose of providing or absorbing reserves. They hope and expect, as I understand it, that providing or absorbing reserves, by purchasing or selling Treasury bills, will quickly be reflected in the cost and availability of all short term credit and, through arbitrage, will also be quickly reflected out through the longer term markets where the price and availability of mortgage money, corporate funds, and funds for State and local improvements are determined. They believe that, only when our open market operations are circumscribed in this way, will the Government security market become freer and more self reliant, and, therefore, help market forces to determine the most desirable allocation of all available funds.

My own view is that just putting in and taking out reserves at the short end of the market, is not always good enough or certain enough. I believe that since this country has wisely rejected most direct controls of our economy, and has placed its chief reliance in the indirect and impersonal controls of fiscal policy, debt management, and monetary policy, we should make the fullest and best integrated use of these tools to contribute to sustained high levels of production, employment and income, and to the stability of the dollar. Otherwise I fear that we shall not be able, at all times and under all circumstances, to do the job we should do, and that our failure will not only lessen the prospects of economic stability, but might also increase the danger of being pushed into direct controls which promise stability, but which really strangle enterprise, efficiency, freedom, and growth.

I am not arguing here against the proposition that the primary purpose of open market operations is to affect the volume of member bank reserves, nor that this can best be accomplished, in many circumstances, by purchases and sales of Treasury bills. I am arguing that putting in or taking out reserves is not the sole purpose of open market operations. And I am arguing that there are times and places when putting reserves in, or taking them out, by way of the Treasury bill market may involve unnecessarily large purchases and sales, or may not promptly find its best reflection in the credit and capital markets of the country because of imperfect arbitrage within markets and between markets. Finally, I am arguing that there have been and may be occasions when some direct assistance to Treasury operations in the field of debt management, through open market operations in securities other than Treasury bills, will be good economics and good central banking.

It is illuminating and perhaps significant that in countries where traditions are most similar to ours, and where the central banks have available a broad market in Government securities in which to conduct operations, there is no such squeamishness as we have exhibited in using that market to influence the whole credit structure and level of interest rates. In a recent statment at a hearing of the Standing Committee on Banking and Commerce of the House of Commons in Canada, the Governor of the Bank of Canada said:

> "As part of our programme to improve and broaden the money market for the benefit of lenders and borrowers and of our financial structure as a whole, the Bank of Canada has been a constant trader in Government of Canada securities since we opened our doors in 1935. While the total amount of our holdings of Government securities is necessarily determined by considerations of monetary policy, we have endeavoured to help make a market for all Government issues and have been very substantial buyers and sellers. In a sense, we perform a jobbing function, holding the inventories which are indispensable to a good market. Investment dealers and banks also operate in this way, although naturally on a smaller scale. We would be glad to see both dealers and banks extend their operations of this character, and have the Bank of Canada play a smaller part, although we would always expect to be a substantial participant in the market."

Each central bank, of course, has to fit itself into its own environment. What others do may not suit our book. But I find it encouraging that such perceptive and knowledgeable people as the Canadians believe there is a middle ground between the extremes of our present approach, on the one hand, and the extremes of our war and immediate post war approach of pegged prices and detailed control over the whole interest rate curve, on the other. It illustrates the statement of a colleague that there should be plenty of useful scope for central bank action between the extremes of chilly indifference and constant intrusion.

Our present situation, in my opinion, provides the Federal Reserve System and, therefore, the country with an opportunity for constructive action in the search for economic stability, which did not exist when the System was established four decades ago. For better or worse we now have a large Federal debt, which overshadows in magnitude all individual private debts and is roughly equal to private debts in the aggregate. This large debt, representing various maturities, has given us a national homogeneous securities market, which to a considerable extent conditions all other security markets (corporate securities, mortgages, etc.). The Federal Reserve System through its authority to engage in open market operations can, if it will, seek to make its policies effective by operations anywhere in the maturity range of this national market for Government securities. This does not mean constant intervention in and manipulation of the market, and it certainly does not mean pegging prices. But it does mean that, if operations in Treasury bills in appropriate amounts, and the subsequent arbitrage within and between markets do not or cannot achieve the desired results, at all times and in all circumstances, direct action by the Federal Reserve may give the process a desirable assist. Similarly, it means that if Treasury debt management operations put a temporary but intense strain on the facilities of the market, in bringing about adjustments in portfolios of thousands of investors in billions of securities, within a short period of time, the largest single portfolio of all should not always stand aloof (except for the purchase or sale of Treasury bills). Direct aid in helping to cushion the effect of massive maturities, new issues, or conversions of Treasury securities, at times when unavoidable Government financing would otherwise disrupt, temporarily, the money and capital markets, would seem to me to be wholly consistent with the primary demands and objectives of monetary policy. The need for such action may be infrequent, but I question whether the central bank should publicly renounce the possibility of such action.

I must admit, though, that some very attractive labels have been put on the bottle from which we are now drinking. "Free markets", "avoidance of price pegging", and dealing in the "nearest thing to money" are examples. I like the appearance and the sound of these labels, but I want to test the contents of the bottle, further, before accepting the promise of the labels.

So far as "free markets" are concerned, I think we are all attracted by the phrase. It suits our habit of mind. But we haven't had a free market in money and credit, at least since the Federal Reserve System was established; and we haven't had a free market in Government securities, and therefore a wholly free securities market, since the Government debt climbed to the higher magnitudes, and open market operations by the Federal Reserve System came to be used as a principal instrument of credit policy. We now have a market in which lenders and borrowers have to and do take account of action and possible action by the Federal Reserve System to alter the supply, availability and cost of reserve funds; a market which has to and does take account of possible actions by the Treasury with respect to debt management and of credit policy in relation to debt management. This will continue to be the situation in a mixed Government-private money and capital market such as we now have, and will continue to have for a long time to come.

I think we should accommodate our ideas of "free markets" in the money sector of the economy to present day conditions. I do not think this will do violence to the "traditions" of central banking. Even in the "good old days" of the nineteenth century, when social and economic conceptions were different, I believe they were practical about such things. They did not suggest that any supplier or user of funds, so large that his every action necessarily affected the anticipations and actions of everyone else in the market, could pretend that markets were made without him. So long as we have a central bank and a large and constantly shifting public debt, both will be powerful and special market influences. Our approach to credit policy, and to debt management as well, should take these facts into account.

I have already intimated that the approach I prefer has nothing to do with price pegging, nor with trying to establish and maintain a particular pattern of interest rates, nor with other practices which during the war and earlier post war years destroyed or handicapped monetary policy. There is a natural and justified aversion to these practices, but this aversion is quite beside the point I am discussing. The issue is not whether to peg or not to peg, but whether at all times and in all circumstances (except for disorderly markets) the System should confine itself to shoving reserves in or taking them out at the bottom of the credit pile. The issue is whether there will not be times when direct operations in other areas will be appropriate and more effective. Almost everyone is agreed, I think, that our intervention in the market should not be to impose a fixed pattern of prices and yields on the market.

Finally, dealing only in the "nearest thing to money" is something of a throwback to a central banking concept of earlier days. Before it was applied to open market operations in Treasury bills this theory or label was applied to the discount, rediscount and purchase of "self liquidating" prime commercial paper. Even then, however, there was always the question of how fast, and how well, and in what circumstances operations in such short term paper would permeate all markets and all maturities. It may be that there is enough fluidity in the Government security market, and between that market and other markets, to solve this problem for us automatically now, but I doubt it. I do not want to tie myself to that hypothesis. If we are going that far, why not take the next step and, instead of dealing in the "nearest thing to money", deal in money itself? Instead of shying away merely from influencing longer term markets directly, why not shy away from influencing the short term market directly? Our operations in Treasury bills can and have caused distortion in the short term market and between short and long markets. In other words, we might merely increase or decrease reserve requirements of particular banks or groups of banks in order to affect reserves directly, without the intervention of even Treasury bills. I introduce the idea only as a sort of reductio ad absurdum; I wouldn't suggest it.

The conflicting views on open market techniques which I have been discussing really do not come to a testing ground in a period such as the present, when general credit policy is to maintain a substantial volume of readily available bank reserves at all times. The whole private market plus the Treasury's debt management program can pretty much float on a sea of reserves. This obscures the view of things which might have been done better. It persuades the advocates of the practices with which I take issue that we have come off pretty well so far. And those who have been persuaded to support this position are comforted by the statement that present practices can be changed at any time if the need becomes apparent; that present policies are to be followed only until such time as they may be superseded or modified by further action of the Federal Open Market Committee. The tendency has been and is, however, to fix these practices as permanent rules of central banking, and to display them to the market as such. The inevitable consequence will be, I think, to make it difficult for men to open their minds to any other mode of operation, even under changing conditions, and to expose us to charges of having misled the market or of violating "promises" to the market if we do change our methods. We could have done about all that we have done, in practice, during the past year, without trying to enshrine a new doctrine of central banking as a permanent "norm". We could have retained our freedom of action to meet changing circumstances without endangering present policy, and without interfering with the proper freedom of our money and security markets.

To sum up, then, I think the central bank should exert its influence on the cost and availability of credit or capital, openly and directly as circumstances may require, in whatever areas of the market it can reach. I think the central bank should be free to aid the market directly in making its adjustments to large scale Treasury financing, whenever such aid can be given without permanently overriding credit policy. I believe that trying always to do these things indirectly, through dealing only in the "nearest thing to money", will not create a "free market", but will keep the central banking system from realizing its full potential.

It has been said, perhaps unkindly, that Americans, in the face of the international responsibilities which have been thrust upon them, are prone to try to find a general formula which will spare them from having to make individual decisions under changing circumstances. Moral pronouncements are used to try to give an air of permanence to things which are essentially impermanent. We want to lay out "rules of the game" which will guide all the players and, if the players are properly numbered, will also guide the spectators. Maybe that is what we have been trying to do in the field of central banking; to establish monetary "norms" in a world which is not normal. I doubt if it can be done, but I think that when it is tried it should have the serious attention of bankers and others who are interested in monetary policy.