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THE BASIS OF FEDERAL RESERVE POLICY

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When observers write and talk about what the Federal Reserve System does, they usually substitute the sophisticated word "policy" for the common word "work". Since the two words really mean the same thing, I suggest we talk about the work of the Federal Reserve System.

There are several things we would like to know:

I. What is the general purpose of the System?

II. What tools does it use?

III. What guides does it follow?

IV. What specifically has the System been doing recently?

V. How are decisions made?

I. What is the general purpose of the System?

The Federal Reserve System was created in 1913 primarily to furnish an elastic currency and thus prevent the recurrent money panics and periods of credit stringency which had characterized the virile but somewhat over-exuberant American banking system during the previous fifty years. The Federal Reserve Act also sought to tie the multitude of individual banks together and provide for a measure of coordination and cooperation among them by erecting a superstructure consisting of twelve regional Reserve Banks which were, in turn, tied together by the Federal Reserve Board in Washington. System authorities were directed to use what was considered their most important power - that to fix discount rates - "with a view of accommodating commerce and business." The exact meaning of these words has been adapted to changing circumstances in the thirty-five years that the System has been in existence. This should occasion no surprise, especially when one recalls that these years have included two world wars and the world's greatest depression.

At present most people probably would agree with a statement of the Board of Governors "that the implicit, predominant purpose of Federal Reserve policy is to contribute, in so far as the limitations of monetary and credit policy permit, to an economic environment favorable to the highest possible degree of sustained production and employment." As one moves to more specific programs of action to achieve this objective, however, he inevitably encounters differences of opinion. Some say the System can best achieve the general purpose by directing its efforts to stabilizing a specific price level; others say, to promoting conditions of full employment; still others, to adhering to a more or less passive role, and so on.

One of the most important continuing problems facing the Reserve officials is to choose among, to reconcile, or to combine such specific objectives. This is easy when the same action is indicated to achieve all possible objectives; but that happy combination rarely occurs in real life. Need for judgment arises as soon as promotion of one objective appears possible only at the expense of promoting another.

I should like to mention a few difficult periods of decision, not to praise or blame the System, but to indicate the necessity for judgment. An understanding of these conflicts will help you to a more complete understanding of the System.

The first major conflict arose in connection with financing the first World War. The Board expressed the problem in these words:

> "Banking expansion, it may be admitted, is an unavoidable incident of war finance, but every effort should nevertheless be made to counteract it as far as possible by limiting banking credit not clearly needed for the purpose of producing or carrying goods necessary for the life of a Nation at war. Goods and credit must be saved to the utmost of our ability in order to check the upward movement of prices and in order to free for the use of the Government the goods and savings required for the winning of the war."

Another conflict developed during the new era of the 1920's when various economic forces began to move seriously in different directions. The Board expressed this conflict as follows:

> "The problem was to find suitable means by which the growing volume of security credit could be brought under orderly restraint without occasioning avoidable pressure on commercial credit and business. With the system portfolio of Government securities practically exhausted by the sales made in the first half of the year 1928, the main reliance in a further firming of money conditions must have been further marking up of Federal Reserve discount rates, unless some other expedient could be brought to bear in the situation."

It was this experience with the great bull market of 1929 that resulted in the introduction of selective instruments of credit control; namely, those over margins on security loans.

The most recent conflict, like the first, arose out of war financing. In the Federal Reserve Bulletin for October 1948, the major two-fold objective is described like this: "...as much restraint on monetary and credit expansion as was consistent with maintenance of orderly and stable conditions in the market for Government securities." You are familiar with the extended discussions as to the relative importance of the two objectives and as to the Board's request for additional authority to resolve the dilemma.

This experience shows that a program of action must be designed to meet the needs of a given situation. Some students recommend that the System give absolute priority to a single objective and forget about the rest; but they have not agreed on which specific objective should be given the high honor. Practicing central bankers rarely if ever take this all-or-nothing approach. They attempt to reconcile objectives - even those that appear irreconcilable on strictly logical grounds. Selective instruments have been developed as a means of escaping some of the dilemmas that arise when choosing objectives. Another alternative to the all-or-nothing approach is to combine objectives so as to achieve each in part though perhaps none entirely.

II. What tools does the System use?

Once objectives have been determined, the problem narrows down to ways and means of accomplishing them. The System attempts to achieve its objectives primarily by influencing the amount, availability, and cost of money. The most important machinery for exercising such influence is through the reserves of member banks. As you know, member banks are required by law to keep certain percentages of their own demand and time deposits as reserve deposits at the Federal Reserve Bank of their District. Decisions of commercial banks with respect to lending and investing are greatly influenced by their actual, required, excess, and potential reserves.

It is primarily through its influence over reserves that the System influences the flow of money. The System has three general instruments to affect the reserves of member banks. Two of these - discount rates and open market operations - affect the volume of reserves, and the third - reserve requirements - limits the amount of bank credit that can be based on a given volume of reserves. These three instruments are closely related. The relative emphasis that has been placed on them has shifted significantly from time to time.

Initially, the Reserve Banks were viewed as relatively passive institutions. They were considered big brothers available as a source of help to their member banks. When members needed reserves, they borrowed from the Reserve Banks. The most active instrument of policy during these earlier days was the rate of rediscount. The rate was increased to discourage borrowing and was decreased to encourage borrowing.

Early in the 1920's, the Reserve Banks began to purchase Government securities to maintain their earnings. Such open market operations were thought to be wholly independent of discounts. It was soon observed, however, that the funds put into the market by the Reserve Banks through security purchases found their way back in large part through repayment of borrowings from the Reserve Banks. In other words, the volume of discounts and open market operations were in fact closely related. Both are avenues of access to the Reserve Banks. The two instruments had to be correlated in an effective over-all policy. The System, therefore, accompanied sales of securities with increasing discount rates to achieve effective restraint, and accompanied purchases with decreasing rates to produce general monetary ease.

Yet the two instruments, though related, were not identical. Sales of securities by the System had some restraining effect even when not accompanied by higher discount rates. In part this arose from the fact that discount rates were usually kept above the yields on the securities in which the System dealt in the open market. Hence, if member banks were forced to obtain reserves by borrowing, the cost of reserves was increased. In the second place, sales of securities were a signal that the System was of the opinion that credit should be tightened. This opinion of the responsible authorities was likely to influence the market.

Sales of securities had yet another effect even though initially offset through borrowing. Commercial bankers manage their institutions according to certain principles and guides. A common guide is to avoid continuous borrowing. Many banks, therefore, although willing to borrow temporarily to meet reserve deficiencies, will contract their credit rapidly or gradually to repay debts. This tradition against rediscounting is not powerful enough in itself to give adequate control over credit expansion, but it is a limiting factor.

These two instruments - the discount rate and open market operations - affect the amount of member bank reserves. The third general instrument - reserve requirements - limits the amount of bank credit that can be based on a given volume of reserves. Authority to change reserve requirements was first granted to the Board of Governors during the depression of the 30's to deal with existing and prospective excess reserves that were beyond the reach of the System's other instruments. We still have a lot to learn about the operation of such changes. We are repeating with reserve requirements the experience we had with open market operations; they cannot be considered in isolation any more than open market operations can be considered independently of discounting.

Differences in judgment as to the effectiveness of changes in reserve requirements arise principally from differences in expectations as to the course of actual reserves - which depend largely on open market operations and discount rates. At one extreme are those who assume that actual reserves will remain unchanged. They conclude that changes in requirements are a powerful weapon forcing a multiple change in deposits. It should be remembered, however, that changes in requirements produce either excesses or deficiencies in reserves and that such excesses and deficiencies, in turn, are powerful factors affecting the demand for actual reserves. To have maximum effect, therefore, increases in requirements must be accompanied by appropriate stiffening of terms on which reserves may be obtained, and decreases in requirements by appropriate easing of terms to stimulate demand for credit and an expansion of bank loans and investments. If the full effect is desired from large changes in requirements, the necessary changes in terms on which reserves or securities are made available are apt to be so large as to interfere with maintenance of orderly conditions in the money market. This may pose a conflict that requires some degree of compromise.

At the other extreme are those who assume that changes in requirements will be accompanied immediately by corresponding changes in actual reserves and who conclude, therefore, that changes in reserve requirements are of negligible influence. This conclusion presupposes that actual reserves or securities will be made available by the System at terms existing when the requirements are changed. Even under such circumstances, however, it should be remembered that changes in requirements have ancillary effects of some importance. In the first place, they are an expression of the judgment of System authorities with respect to credit developments. An increase means that the System wishes to restrain credit and a decrease that it wishes to stimulate credit. Such judgments by System authorities influence credit developments. In the second place, changes in reserve requirements affect the amount of funds that banks can and are willing to lend and invest. To be sure, a bank may make good a reserve deficiency arising from an increase in requirements by selling Government securities. But it will then have fewer such securities and will probably be less inclined to dispose of still more in order to expand its loans and other earning assets. Similarly, an increase in requirements reduces both the ability and willingness of banks to expand on the basis of excess or accruing reserves. A potential increase has similar effects when it appears imminent. I have found a few bankers who have said they would expand other earning assets to offset the actual or prospective decline in earnings, but they have been a small minority.

As I have said, we still have much to learn about the operation of changes in reserve requirements. My present conclusions, which are influenced by many hours of discussion with bankers in the Third Federal Reserve District, are that they have some effect in the desired direction on the availability of credit even when unaccompanied by changes in rates and yields but that larger effects can be expected only if accompanied by changes in rates and yields.

In addition to the three general instruments to influence the amount, availability and cost of bank reserves, the System has authority to regulate minimum margins on security purchases and sales. On emergency bases it also regulated consumer instalment credit for limited periods. The purpose of such selective instruments is to adapt credit to diverse developments in different and relatively segregated fields.

III. What guides does the System follow?

The art of central banking is the proper use of these available instruments to achieve desired objectives in the real world. An omniscient central banker would know exactly what to do at all times. Practicing central bankers, however, are forced to devise useful guides to indicate the direction and speed with which they should act. They must diagnose the ills of the economy before they can prescribe an effective remedy. This requires a continual check of symptoms which reveal the state of our economic health.

The System publishes each month the principal graphic material used by the authorities. This chart book contains comprehensive information on bank credit, money rates, and business. Obviously there are many important factors that defy statistical measurement. The prospective direction and strength of the many forces operating in the economy are matters on which judgments differ. The staff prepares comprehensive analyses of possible alternative developments based on various assumptions. These are some of the materials that central bankers employ in arriving at decisions as to the nature of the problems confronting us and the specific actions needed to solve them.

IV. What specifically has the System been doing recently?

The Federal Reserve authorities operate in the real world. The general objective of economic stability remains the same, but the actions taken to promote it must be suited to the situation that exists and must, therefore, be adapted to changes in economic conditions. Excessive expansion calls for a program of restraint, excessive contraction calls for a program of stimulation. I mention this need for flexibility because the System is sometimes accused of inconsistency when it reverses a program. The consistency that is important is that concerning objectives, not that concerning programs of action.

As you know, the System has changed its program since the meeting of this Forum last September. At that time the problem was too much money and inflation. A month later the program then being followed was described in the Federal Reserve Bulletin in these words:

> "Since the war, and particularly since mid-1947, Federal Reserve credit policies and the Treasury fiscal and debt management program have had as a major objective as much restraint on monetary and credit expansion as was consistent with maintenance of orderly and stable conditions in the market for Government securities. Action toward this objective on the basis of existing powers included focus of the Treasury program of debt retirement on securities held by the Federal Reserve Banks; upward adjustments of rates on short-term Government securities and in Federal Reserve discount rates; reduction in Federal Reserve support prices for medium-term and long-term Government securities; increase in reserve requirements..."

At that time many over-all indicators were still establishing new post-war highs. One can reconstruct a better impression of conditions as they appeared at the time if he looks at the chart book published a year ago rather than the most recent issue. A director of the Philadelphia Reserve Bank phrases this difference in these words: "I have 20/20 vision only when looking at the past."

As events have turned out, the decision to increase reserve requirements which became effective in September 1928 was the last formal decision by the System to increase restraints.

The endless flow of information began to indicate that this particular crest of inflation was over. The problem became one of making reserves more plentiful and of checking contraction. Beginning in March of this year a series of decisions have been taken to relax restraints on credit. On March 2 Regulation W on consumer instalment credit was relaxed. On March 28 margin requirements were reduced from 75% to 50%. On April 22 Regulation W was further relaxed. On April 28 reserve requirements were reduced by about $1¼ billion. On June 28 the Federal Open Market Committee announced "that with a view to increasing the supply of funds available in the market to meet the needs of commerce, business, and agriculture" purchases, sales, and exchanges of Government securities would be made with "primary regard to the general business and credit situation." With the lapse of the Board's temporary authority on June 30, there was another reduction in reserve requirements, totaling about $800 million, and regulation of consumer instalment credit was terminated. In August reserve requirements were reduced further in a series of steps, the total amounting to about $1.8 billion.

In announcements and comments on these various actions, Reserve officials have emphasized time and again "that credit regulations are not a one-way street. They should be tightened or relaxed as general economic conditions require." This emphasis is properly placed. No one can now know how soon it may be necessary to increase restraints again.

When and so long as general economic conditions - including the imponderables! - deteriorate, the appropriate program is to relax. The three available general instruments are reductions in reserve requirements, purchases of securities, and reductions in discount rates. I would like, however, to re-emphasize what I said before about these instruments. They are closely related. For instance, the System is always interested in an orderly money market. You may find, therefore, that if, for example, reserves released by a reduction in requirements are creating temporary disorder in the money market, the System may reduce its holdings of securities. Such an operation should not be interpreted as a reversal of policy or inconsistency. It may be compared to the receipt of change when payment is made in a note that is larger than the bill.

V. How are decisions made?

Decisions are made by people. In the United States we value democracy and group judgment above consistency and centralized efficiency. In keeping with our experience, we organized a federal system rather than a central bank. We have made changes from time to time to meet particular circumstances, but not always with regard to how neatly the parts fit together. As a result, our present complex organization is a never-ending source of irritation to teachers and especially to students of banking. For example, we have seen that the three major instruments of general credit policy are intimately related. Yet, according to the Federal Reserve Act, rates of discount are established by the Federal Reserve Banks subject to review and determination of the Federal Reserve Board; open market operations are regulated by the Federal Open Market Committee, which consists of the members of the Board and the representatives - actually the Presidents in rotation - of five Reserve Banks; while reserve requirements are determined within legal limits by the Board. No one would allocate powers in this way if he were starting from scratch.

All decisions have one thing in common: they are group judgments. Now a group judgment is something more than the judgment of any single member - and it is something more than the mere addition of the independently acquired judgments of the several members.

The complexities of the original organization arose in part from the desire of the founders to assure that the judgment of each agency would reflect consideration of possible differences in views. There have been some changes in details but the present law still reflects this approach.

In selecting members for the national agency - the Board of Governors - the President is directed to "have due regard to a fair representation of the financial, agricultural, industrial, and commercial interests, and geographical divisions of the country."

Similarly, the nine directors of each district Reserve Bank are divided into three classes representing the points of view of the lenders, of the borrowers, and of the general public. To assure wide coverage of views, member banks are divided into three groups based on size for the selection of Class A and Class B directors. The several boards of directors, subject to the approval of the Board of Governors, select the Presidents, or chief executive officers, of the Reserve Banks. The intention of the organizers was that decisions should reflect the combined judgment of groups of officials who had a variety of experience, not that each official should take a narrow view of benefit to a particular interest. The real intention has been realized in practice. The officials are acutely aware that their responsibility is to promote the general economic welfare of the entire country.

We may take a meeting of the Federal Open Market Committee as representative of the way in which decisions are reached. Ordinarily a meeting is held just after a Conference of Presidents of the Reserve Banks and, in addition to the members, is attended by the remaining Presidents and a number of senior staff members of the Board and the Reserve Banks.

Current developments are reviewed and subjected to extensive discussion. Important materials are the memoranda, analyses, and charts that I have mentioned as guides to action. Each participant brings to the discussion his best thought, information, and judgment.

The contacts of the System, like the System itself, span the country. This meeting today is an excellent example of how the System keeps in touch with what is going on. The Reserve Banks, each in its own way, do their best to keep informed. Consequently, the Presidents of Reserve Banks can bring to the meeting an intimate knowledge of local and national developments, as well as the practical experience gained from serving as chief operating officers at their Banks. Collectively they are in intimate daily contact with the money markets as well as all other phases of economic activity.

Each final decision is the combined judgment of the group. Group judgment differs from individual judgment because it frequently means that more factors, as well as more people, are taken into account in arriving at decisions. The record of all policy actions as well as the votes and reasons underlying such actions are published in the Annual Reports of the Board of Governors. In studying these records it is well to keep in mind that the exact decision is not necessarily the same as would be made by any member acting in isolation; it is a combined judgment. It is helpful also to keep in mind that differences may arise between observers and participants because of the difference in their responsibility. It is one thing to sit on the hot seat; it is another to point a finger at the person who is on the hot seat. The military genius, von Clausewitz, recognized this when he distinguished between the principles of war and the conduct of war itself. He said: "The results on which we count in warfare are never as precise as is imagined by someone who has not carefully observed a war and become used to it."

In testifying before the Senate Committee on Banking and Currency last May, Chairman McCabe described the process of reaching decisions in these words:

> "Before coming to decisions on all matters of policy, the Reserve Board has the inestimable advantage of being able to communicate with and obtain factual information, as well as opinions, from the twelve Federal

Reserve Banks and their twenty-four branches throughout the country, on whose boards are more than 250 directors, drawn not only from banking but from the widely diversified industrial, commercial, agricultural, and professional pursuits of the nation. The directors, the officers, and staffs of the Reserve Banks and the Board, the Federal Advisory Council, and the member banks comprise the Reserve System which, as I have often said, is like a vast pyramid, whose breadth and strength is in its base. The Board has constantly available current information, drawn from this great System to supplement the vast mass of factual and statistical data gathered through other governmental sources. Moreover, the System sponsors special studies as occasion demands. In addition, we are always at pains to consult with representative businessmen, the small as well as the larger ones, with trade associations and, in fact, with all who are affected by System operations. We try to weigh carefully their views and to distinguish broad national considerations from those reflecting narrower interests. I mention these myriad sources of information to emphasize that we do not function in a vacuum."

VI. Concluding Comments

Federal Reserve policy is what the people in the Federal Reserve System do. I know a lot of these people personally. They are not unique. If they were to mingle in a crowd walking down the street on Easter Sunday, you could not identify them. They put on their trousers one leg at a time as do other men.

They are responsible for exercising judgment in the field of money and credit. Here, too, they are human; they will not always agree. Their group decisions will be criticized. The many others who are competent in this field have a right to express their views. In a democracy, indeed, they have a responsibility to do so. In the long history of the System, views expressed outside official circles have not been without influence on what has been done.

Observation and study of central banking happens to be my specialty. But I am not as convinced of any principle of central banking as I am that the democratic method of free discussion produces the best results in the long run and that it is the best method that people have yet devised to live together.

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