COMMENTS

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on

"Developments and Implications of Federal Reserve Policy"
by Prof. Walter A. Morton, University of Wisconsin

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I should like to state at the outset that I agree with Professor Morton's view that general monetary policy is a necessary but by no means a sufficient condition "to maintain a high level of economic opportunity". Perhaps, therefore, I can contribute most to this session not by emphasizing our differences -- some of which I feel sure are more semantic than real -- but by paralleling his discussion with brief comments on the view that recent institutional developments have changed fundamentally and essentially the role of general monetary policy.

It is still commonly recognized, of course, that commercial banks are unique in that their demand deposits are money. But the question has been raised as to whether the base on which the central bank operates has become too small for effective action because of the rapid development of other types of financial institutions that compete with commercial banks in many ways.

A common approach to the problem runs as follows: The monetary authorities regulate the amount of reserves available to the commercial banks. Commercial banks adjust their lending and investing activities to their reserve positions and thus influence the amount of deposit money. When reserves are tight in a period of restraint, banks will limit their lending by charging more and by screening applications more rigorously. If, now, banks are the only source of credit open to the borrower, the restraining monetary policy can be effective. If, on the other hand, the borrower can turn to other sources, the influence of the monetary authorities is dissipated.

Some observers have concluded from the analysis that runs in these terms that the monetary authorities should be given regulatory power over other financial institutions in order to restore their effectiveness. I agree that such regulations could affect the competitive positions and the relative profitability of financial institutions as well as the allocation of credit among competing users. I agree also, that the differential impact of general monetary policy is important and has become a matter of increasing concern.

I do not have time to discuss this aspect of the problem. But I would like to point out that one consequence of the institutional developments of recent decades is that both borrowers and lenders have more options. A man who wishes to finance the purchase of a house or of an automobile can apply at several different types of institutions. Alternatively, one who wishes to save in liquid forms has numerous options. Banks and other institutional lenders in turn may lend to consumers, to home owners, to business firms, and others. Is it not reasonable to suppose that as the number of options increases -- as the network of credit contacts becomes more elaborate -- the influence of the monetary authorities permeates the economy more thoroughly and more quickly? Incidentally, doesn't the widespread ownership of the Federal debt operate in the same direction? Doesn't the credit market become more fluid and doesn't the burden of distributing credit fall more on price and less on administration or rationing?

This brings me back to the question of whether regulation of other financial institutions would make over-all monetary policy significantly more effective. One suggestion is that other financial institutions be required to maintain minimum cash reserves.

Presumably, to exercise restraint, the minimum requirements would be set above the actual reserves. Where would the additional cash come from? Since there is no inherent reason why the assets of such institutions would increase automatically by the appropriate amounts, the institutions would have to borrow or liquidate non-cash assets. Either would tighten the money market. If that is the purpose, it can be achieved under existing institutional arrangements. If it is not the purpose, what general monetary results would be achieved by the new regulations? Perhaps I have a blind spot, but I cannot trace the links in the mechanism by which even detailed regulation of all financial institutions by the monetary authorities would resolve the dilemma between unemployment and inflation that Professor Morton poses.

This is not, of course, the first time that observers have remarked about a developing impotence of a central bank. Often enough, incidentally, the remarks were based on growing competition of other lenders who presumably escaped control. To be sure, in some episodes, it was competition of commercial banks with the central bank rather than between non-bank and bank lenders. But the essential core of the problem has been the same.

Our Chairman, Professor Wood, has analyzed the experience of the Bank of England during the 19th Century. The question then was whether the commercial banks could escape the control of the Bank of England by reducing their reserve proportions. He concludes that they could not because, as he puts it, "at no time down to 1913 were the total private securities of the Bank unmanageably small in relation to total bankers' cash. Whether the banks, therefore, chose to adjust their reserve proportions at 8 per cent or 15 per cent, the terms of the Bank had to be met."

I have analyzed the experience of the Reichsbank during the period 1876 to 1914 with similar results. During the first half of the period the complaint was that the banks with limited powers to issue notes could nullify the powers of the Reichsbank, and during the second half it was that the commercial banks could do so. The German commercial banks did not observe any legal or customary relationships between their reserves and their deposits. Nevertheless, whatever reserves they wished to keep had to be secured from the Reichsbank whose earning assets were always much larger than total cash assets of the commercial banks. In short, the Reichsbank like the Bank of England could influence powerfully the terms and conditions under which banks could adjust their reserves. The Reichsbank was also able to influence the terms and conditions under which certain other borrowers acquired cash directly since it was a large commercial bank as well as a central bank. It was through these powers that the Bank of England and the Reichsbank were able to influence the attractiveness of cash relative to debt assets on the one hand and real assets on the other, and thereby achieve their purposes.

I have cited these two cases because it seems to me that they contain elements that are relevant to our own problems. May we not also be exaggerating the newly developed ability and willingness of the private non-banking sector to nullify the intentions of the monetary authorities? What we have witnessed is a great increase in the availability of partial substitutes for cash. This development has reduced the need of the public for deposit balances. The significant matters from the point of view of monetary control, however, are: 1) that whatever amount of cash balances the public needs it must obtain under conditions greatly influenced by the monetary authorities, and 2) that these conditions, or the attractiveness of cash relative to debt assets on the one hand and real assets on the other, influence the flow of expenditures and thus the general level of economic activity.

My conclusion, that recent developments of financial institutions have not seriously blunted the general tools of monetary policy, should not be interpreted to mean that I think appropriate general monetary policy alone can assure high levels of employment at a stable level of prices. Nor do I believe that central banking is easy. I may have believed that when I left teaching to become a practitioner; I don't any more.

(for publication)

My conclusion that the tools of central banks have not been blunted seriously by the developments I have described should not be misinterpreted to mean that I think monetary policy alone can assure us of high levels of employment at a stable level of prices. Nor do I wish to leave the impression that central banking is easy. I may have believed that when I left teaching to become a practitioner. I do not any more.