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Federal Reserve Bank
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A FLEXIBLE MONETARY POLICY

by Karl R. Bopp, Vice President
Federal Reserve Bank of Philadelphia
before Group Two, Pennsylvania Bankers Association
Bellevue-Stratford Hotel, Philadelphia, Pa.
Saturday, February 8, 1958

I would like at the very outset to express my sincere appreciation for the good wishes that so many of you have expressed. I can hope for no more than that you will feel as kindly toward me when my turn comes to retire as you feel now when I am about to assume the challenging responsibilities that lie ahead.

I seize this first opportunity since the announcement of the retirement of Alfred H. Williams as President of the Federal Reserve Bank of Philadelphia and W. Jonathan Davis as First Vice President to pay tribute to these two great public servants. All of you know Al and John very well; nevertheless, I venture the judgment that none of you knows them as well as Bob Hilkert and I who succeed them on March 1. Al Williams is incomparable, unique. There is no second Al Williams and there never will be - and there never will be a second John Davis either.

Fortunately, Bob and I have lived and worked intimately with them for more than fifteen years. They have done their best to develop in us the qualities that our jobs demand: An open mind that bases its

decisions on the relevant evidence, awareness of personal fallibility even when motives are pure, courage to do what is in the public interest even though it may occasionally be unpleasant. They never lost sight of the dignity and importance of every individual. We are ambitious to maintain in the Bank an environment in which each of the thousand individuals on the staff will derive zest from making his or her maximum contribution to the important work of the Bank.

The title of these remarks, a flexible monetary policy, indicates that we intend to continue the efforts inaugurated by President Williams to explain the role of the Federal Reserve System in our dynamic economy. It is in the national interest that the role of the System be understood without exaggeration or minimization. This is a substantial undertaking that cannot be completed at one session. I shall, therefore, discuss today a few aspects of the problems that are of current and continuing importance.

One feature that needs to be understood is that a central banker cannot discuss possible future actions. This necessity arises from the very nature of the problem and not from any desire on the part of the central banker to be mysterious or reticent. Since some of you may have come with the expectation of hearing a discussion of future policy, I shall begin by demonstrating why I cannot satisfy that expectation either today or at any time in the future. One reason is that such a statement injects a new force into the situation. An act that may have been appropriate before the statement was made may not be appropriate after it is made. The options then confronting the central banker who has talked of the future is either to act as he said he would - even

though it is no longer appropriate - or not to act in that way and thus falsify his own predictions. I am sure you will agree that a central banker should not place himself in this dilemma.

Perhaps I can make this point more vivid by reference to other fields. You all remember Pat's reply to Mike who wondered why Pat wanted to know where he was going to die: "Because then I wouldn't go there." No one should be put in the position of telling Pat where he is going to die.

Here is another illustration. Suppose that I had developed a formula by which I could predict with precision the daily movement of the price of a particular stock for a week in advance. Suppose, also, that I had done this for the past five years and that I had delivered each prediction under seal to a notary. Suppose next that I had brought the notary to this meeting to open the predictions and compare them with the actual behavior of the price of the stock and that the predictions had been perfect. And now suppose, finally, that I make the dramatic announcement: "On the basis of my formula the price of the stock will rise \$x a share to \$y on Thursday, February 13, 1958." Do you think it would? I have a hunch that Monday, not Thursday, would be the big day on the Exchange in that stock. The important point, however, for our purposes is that what might have been appropriate before the announcement might not be appropriate after it.

This principle is important in central banking. A central bank exerts its influence primarily through the money market. Its operations affect the supply and availability of money relative to the demand and thereby the cost. Injections of funds tend to ease the market and

withdrawals tend to tighten it. But the tone of the market is also influenced by the expectations of those who deal in it. If they expect the market to ease, lenders will try to lend funds before the easing results in a decline in rates and borrowers will try to postpone their borrowing until rates have declined. In other words, the expectations of ease will increase the current supply of funds and will reduce the current demand and thus will themselves produce the conditions that are anticipated. An easing in the market brought about in this way may not continue, however, if there is no actual increase in funds. But the timing of such release as well as the rate and terms needed to produce and maintain a given tone in the market will be influenced by the change in expectations.

I have neither the time nor, frankly, the competence to analyze all of the ramifications of this problem. I hope I have said enough to indicate that a central banker cannot say what he will do next.

A flexible monetary policy means that the responsible officials act in accordance with their view of the current situation, not in accord with any prior commitment.

I appreciate, of course, that there have been dramatic occasions in the past - such as the outbreak of war - when it has been in the public interest for a central bank to commit itself. We all hope that no such occasion arises again, but if it does, you can be sure that the Federal Reserve System will deliver on any commitment it makes.

Another important facet of this problem is that a central banker is a public servant. He cannot do his job and profit personally or permit others to profit, even inadvertently, from any prior knowledge that he may possess.

Within the limits that I have indicated, the System keeps the public informed of its activities. I happen to have studied central banking in a number of European countries before the Second World War. One of the most frustrating aspects of those studies was the difficulty of securing information. In contrast, the Federal Reserve System informs the public of its operations. There is first of all the Annual Report of the Board of Governors which contains a record of all policy actions of the Federal Open Market Committee as well as of the Board itself. Included are all directives issued by the Committee to the Federal Reserve Bank of New York with respect to operations in the open market. For the reasons I have already indicated, these directives are not made public prior to issuance of the Annual Report. The Annual Report also contains a complete list of the holdings of Government securities by the Federal Reserve Banks at the end of the year. Each week the System publishes the statement of condition of the Federal Reserve Banks, including a breakdown of Government security holdings by type and maturity. The information is available to anyone who wishes to have it.

I need not tell you as bankers that the meaning of the statement and of changes in the magnitudes is not obvious to a casual observer. I need not tell you either that it is worth a good deal of effort to become skilled in the analysis of the statement.

With a desire to be helpful in developing such skill, I would like to point out a few pitfalls in analysis that I have observed in recent years.

The first arises from the unexpressed assumptions that the Reserve System is the only institution that puts money into the market or

takes money out and that it does so exclusively through open market operations. These mistaken assumptions lead to the false conclusion that one can determine the direction of Federal Reserve policy simply by following the System's portfolio of Government securities. Persons who make those assumptions become confused when the System buys securities in a period of tight money or sells securities in a period of ease.

The confusion disappears as soon as one changes his assumptions to reflect the realities of the money market. Actually there are many operations besides purchases and sales of Government securities by the Federal Reserve System that put money into the market or take it out.

For example, the American public gradually withdraws currency from the banks toward the end of the year and returns it to the banks in January. The amount involved is about a billion dollars. It should not confuse an observer to notice that the Federal Reserve System has purchased Government securities toward the end of the year as currency was withdrawn even though it is pursuing a policy of restraint. Nor should it cause confusion to see the System sell securities in January even though it is pursuing a policy of ease.

A strategic feature to keep in mind when analyzing the money market is that all other operations that put funds into the market or withdraw funds from the market have an impact on the reserves of the member banks. It is the reserve position of the member banks that deserves the focus of attention. One measure of the tone of the money market is the net reserve position of the member banks. If banks are able to maintain their required reserves only by borrowing from the Federal Reserve Banks, they will be under pressure to limit their loans and investments.

If, on the other hand, they have excess reserves beyond their requirements, they will be under inducement to expand their loans and investments.

At any moment of time, of course, some banks are borrowing to maintain their required reserves, some have excess reserves, and some, interestingly enough, are borrowing even though they have excess reserves. The net position of the banking system is measured by subtracting the amount of borrowing from the amount of excess reserves. The tone of the money market is greatly influenced by the net position: a net borrowing position being reflected in a tighter market and a net free reserve position being reflected in an easier market. The tone of the market is also influenced, of course, by the distribution of the borrowings and the excess reserves among the member banks.

The System publishes information on borrowing and on excess reserves in its weekly release. When you consider the magnitude and complexity of the forces in the money market and the impossibility of predicting their behavior accurately even a day or two in advance, you will appreciate, of course, that not every change in the net reserve position of the banking system reflects a change in Federal Reserve policy. But the general level over time is important.

Another measure of conditions in the money market is the cost of money. One of the tools that the System uses is the rate at which the Reserve Banks discount the notes of their members. Each Reserve Bank establishes such a rate subject to review and determination by the Board of Governors.

A change in the rate, of course, is news. It is understandable that question will be raised as to why the change was made. Unfortunately,

it is not possible to give a brief and accurate description of why the specific decision was made.

Occasional misunderstanding on this score arises because we are tempted to apply different standards in judging others than we apply in judging ourselves. W. Somerset Maugham had something to say about this problem in his reminiscences published as "The Summing Up."

We all have shared the experience of trying to determine why a relative, a friend, a customer or a public official behaved as he did. We become impatient with elaborate explanations and are tempted to believe they are designed to cover a few simple - and perhaps base or embarrassing motives. We are tempted to say, "Get to the point! Why - in two or three sentences - did you do it?"

How different it all seems when we are on the receiving end of such questions! Again, we become impatient; not now with elaborate explanations, but rather with the demand for brevity!

How, then, can one explain why a given decision was reached? The answer must be based on all the surrounding circumstances. Rarely will one or two factors be decisive.

Each month the Board of Governors publishes the Federal Reserve Bulletin with more than 60 pages of statistical tables and a Chart Book on Financial and Business Statistics with about 60 pages of charts of economic magnitudes that are relevant in reaching a decision on monetary policy. Each Federal Reserve Bank, in turn, has data on developments in its own district. In addition, many non-systematic and qualitative factors are relevant.

I am not so naive as to say that the full implication of all relevant forces is taken into account - or even known - in reaching a

decision. We are not yet living in the millennium! But I do think that mere mention of these areas of information should make it apparent that decisions on policy are based on judgments as to the net effect of a wide variety of forces that are operating in our dynamic economy.

Formation of such a judgment is hard work. I can appreciate that many would find it dull and unexciting. For myself, I find it so enormously important and stimulating that no effort is too great if it results in even a single improvement in judgment. Since, as John Donne said: "No man is an island unto himself", I am happy to have the active support of my thousand colleagues at all levels at the Federal Reserve Bank of Philadelphia.

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Indication of future actions

One feature that needs to be understood is that a central banker cannot indicate possible future actions. This necessity arises from the very nature of the problem and not from any desire on the part of the central banker to be mysterious or reticent. Since some of you may have come with the expectation of hearing a discussion of future policy, I shall begin by demonstrating why I cannot satisfy that expectation either today or at any time in the future. One reason is that such a statement injects a new force into the situation. An act that may have been appropriate before the statement was made may not be appropriate after it is made. The options then confronting the central banker who has talked of the future is either to act as he said he would—even though it is no longer appropriate—or not to act in that way and thus falsify his own predictions. I am sure you will agree that a central banker should not place himself in this dilemma.

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Reasons for policy actions

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