A CHALLENGE TO MONETARY POLICY

Speech by Darryl R. Francis
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There has been a great revival of interest in the use of monetary tools for stabilization purposes in recent years. How great this move from obscurity to renown has been can be observed from an examination of both textbooks and financial papers. Most economic textbooks now contain chapters on monetary theory, whereas two decades ago this topic was largely ignored in classroom discussion. Similarly, the financial press gives much more space to monetary affairs than formerly. Monetary discussions have permeated both the economics profession and the political arena.

We need only go back to the early post-World War II years to find monetary policy objectives limited to the maintenance of low interest rates. In 1945, E. A. Goldenweiser, Director, Division of Research and Statistics of the Federal Reserve Board, stated, "In the monetary field we must in the first place maintain the value of Government bonds . . . This country will have to adjust itself to a 2 1/2 per cent interest rate as the return on safe, long-time money . . ."[1/]

1/ E. A. Goldenweiser, "Postwar Problems and Policies", Federal Reserve Bulletin, Feb. 1945, p. 117.

Throughout the 1940's and 1950's monetary and credit policy took a back seat to fiscal policy in stabilization plans. In 1948 Arthur Smithies, in <u>A Survey of Contemporary Economics</u>, wrote, "In the field of compensatory action, I believe fiscal policy must shoulder most of the load. Its chief rival, monetary policy, seems to be disqualified on institutional grounds. This country appears to be committed to something like the present low level of interest rates on a long-term basis".[2/]

In contrast to the policy of low interest rate maintenance of the 1940's, the pendulum has swung back much closer to the 1920's when great potency was attributed to monetary actions. The nation experienced a number of visible demonstrations of the power of monetary actions in this period. Monetary restraint in early 1923 was followed closely by a downturn in business activity. An easier monetary policy in late 1923 and early 1924 was followed by a business upturn in mid-1924. Some monetary restraint in the third quarter of 1926 was followed by an October downturn in business. These changes in economic activity, following the announced policy changes, produced great confidence both within and outside the System as to the effectiveness of monetary actions. This confidence went

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2/ H. S. Ellis, ed., <u>A Survey of Contemporary Economics</u>, (Philadelphia: Blakiston Co., 1948), p. 208.

far beyond our current ideas as to what can and should be controlled by the monetary authorities. It was generally believed that numerous economic and social objectives could be achieved simultaneously through monetary actions.

In a discussion of monetary objectives during the 1920's, Benjamin Strong, Governor of the Federal Reserve Bank of New York and one of the leading architects of System policy noted "some people think that prices should be the guide, which comes close indeed to thinking that the Reserve System can and should fix prices".[3/] He further points out, however, that there are influences other than prices which affect monetary policy including the following:

"Is labor fully employed?

Are stocks of goods increasing or decreasing?

Is production up to the country's capacity?

Are transportation facilities fully taxed?

Is speculation creeping into the productive and distributive processes?

Are orders and repeat orders being booked much ahead?

Are bills being promptly paid?

Are people spending wastefully?

Is credit expanding?

Are market rates above or below Reserve Bank rates?"

3/ W. Randolph Burgess, ed., Interpretations of Federal Reserve Policy in the Speeches and Writings of Benjamin Strong. (New York: Harper & Brothers, 1930) pp. 233-234.

These questions indicate the great concern of the monetary authorities for factors having little to do with economic stabilization. For example, deciding how the System should react to wasteful spending, speculation, and tardy bill paying would tax the imagination of authorities even in a nation that attempted to morally upgrade its citizens with Prohibition. This confusion in the Twenties as to appropriate objectives led to attempts to induce Congress to require the Reserve System to make price stabilization its primary objective.[4/] It was largely the Federal Reserve System that opposed the stabilization bills in Congress. Governor Strong feared that the public would be unable to distinguish between stabilization of the general price level and prices of individual commodities.[5/]

With this wide range of moral and economic criteria for determining monetary policy, it was inevitable that conflicts would develop between the various discretionary objectives. Further complicating monetary thought at the time was the traditional "real bills or needs of trade" doctrine. In effect, it implied an expansive monetary policy as business was expanding and a contractive policy while business was contracting, rather than action in the opposite direction to

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4/ Lloyd W. Mints, A History of Banking Theory (Chicago: University of Chicago Press, 1945) p. 272.

5/ Burgess, p. 272.

excessive business gyrations. This doctrine was built into the System and, through its policy of contractive actions, the System was a major contributor to the Great Depression as the economy contracted in the late 1920's and early 1930's. Economic stabilization objectives during this period were secondary to the maintenance of the gold standard, the stability of exchanges, and other monetary objectives.

In a discussion of the objectives of monetary policy in 1937, after the economy had been depressed for a number of years, the Federal Reserve Board continued to give low priority to price stabilization as an adequate monetary objective. It stated that "price stability should not be the sole or principal objective of monetary policy . . . . Proposals of price stability necessarily refer to some index or average of prices. There is no general agreement on the question of what constitutes a satisfactory price index for this purpose . . . Correspondence between price stability and economic stability is not sufficiently close, therefore, to make it desirable to restrict the objective of monetary policy to price stability." 6/ With a multiplicity of objectives and an absence of priorities, the System was never in a position of having to accept responsibility for economic

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6/ Federal Reserve Bulletin, September 1937, pp. 827-28.

events. It could always fall back on the historians' type of analysis that all major events were the inevitable result of a prolonged buildup of causal factors and little could be done to alter this course.

The preoccupation ofthe monetary authorities with factors that have little or nothing to do with economic stabilization has carried over into the 1960's. The current concern for the level of interest rates, the balance of payments, Government debt financing problems, stock market credit, loan liquidity, viability of financial agencies, and flows of credit into specific sectors of the economy is strikingly similar to the concern for non-stabilization objectives in the 1920's.

The extent that non-stabilization objectives have been incorporated into monetary policy since 1953 can be demonstrated by statistical analysis. Research at this Bank indicates that only about one-fifth of Federal Reserve behavior with respect to monetary actions during the period 1953-1968 can be explained by economic stabilization objectives. The remainder are explained either by "even-keel" or financial objectives.[7/] Financial objectives, other than even-keel operations, in this analysis include all behavior

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7/ Michael W. Keran and Christopher T. Babb, "An Explanation of Federal Reserve Actions (1933-68)", Review, Federal Reserve Bank of St. Louis, July 1969, p. 14.

designed to protect financial markets. The signals for those actions are deviations from "normal" interest rates. Higher than normal rates indicate to the System that its actions should become more expansive by supplying additional funds to the credit markets. This action is believed to relieve financial institutions of stress and provide more funds to the savings and loan associations and the residential housing industry. On the other hand, lower than normal interest rates cause concern for "sloppy" financial markets and future inflations.

The even-keel objective discussed by Norman Bowsher is a carryover from the World War II and early postwar practice of supporting Government bond prices at low rates in an attempt to reduce the burden of the debt on taxpayers and to prevent bondholders from sustaining losses on their bonds. More recently, the objective of "even-keeling" has been to reduce the financial risk to Government bond dealers who make the initial purchases. Apparently, it is assumed that this favorable policy with respect to dealers in contrast to that of investors will provide lower cost Government debt financing. I believe, however, that the link from dealer to ultimate investor is just as important as the Government-dealer link. If investors are faced with rising rates immediately after purchasing Government securities from dealers, they can be expected to discount the expected interest rate movements during future offerings. Also, corporate financing can be expected to occur more frequently during these more favorable rate periods. An auction of all Government debt in orderly quantities would relieve the Treasury of concern for under-subscribed issues and the Federal Reserve of "even-keeling", which is a consequence of the Treasury's reliance on fixed price issues.

The current preoccupation of the monetary authorities with factors having little relation to stabilization is also reflected in the concern of the System for speculative actions and credit quality. Similar to the supposed danger of the growth of speculative loans in 1928-29, we are currently witnessing a major effort to prevent further speculation in stock purchases by including in the regulations the coverage of numerous unlisted firms. Reasons for these actions are obscure. Current measures to prevent speculation may have resulted from the original idea that such activities would absorb funds to the prejudice of "productive commercial interests". Borrowing for speculative purposes could cause higher rates to commercial borrowers. This line of reasoning, however, does not prove fruitful if one pursues it to its ultimate impact on national output. General welfare may be enhanced just as much by stock market credit as by any other type of credit.

There is also an ethical question as to whether individual purchases of stock with credit are basically different from other capital purchases with the use of bank credit. In my view one can "speculate" with credit by purchasing anything of value.

Furthermore, there is a basic question as to the appropriateness of restricting credit for speculating or investing in a free society. In addition to the problem of deciding whether or not an act is one of speculation or investment, there is a question as to whether speculation should be restricted as long as the general public interest is not affected adversely. Personal freedom is maximized when we permit each person all the liberty desired so long as no other person is damaged. When both borrower and lender are satisfied with a credit arrangement, we are not sure that credit for common stock purchase is more harmful to social welfare than credit for the purchase of any other item.

As I close out this brief review of Federal Reserve objectives during the past half-century, I will quote an item from Theodore Morgan's excellent paper entitled, "The Theory of Error in Centrally Directed Economic Systems", published in the August 1964 Quarterly Journal of Economics.[8/] Professor Morgan stated that "The first general rule is that central direction in economic affairs leads to fewer but bigger errors...The self-interest of any administrative group lies in its reputation for good performance. Hence the group is sensitive to the tests of performance that can be applied to it". He further notes that one reason for this tendency for big organizations to make big errors is that "the expression of a point of view by the chief puts blinders on the staff of an office or department".

Because of the possibility of major errors by large organizations, great freedom of expression is desirable for each Federal Reserve Bank and the Board. Such freedom is taken in making the following proposals for conducting monetary policy in the years ahead.

First, I propose the total elimination or relegation to a low priority of the following factors involved in past monetary deliberations, namely, interest rate levels, balance of payments, viability of financial intermediaries, even-keeling and other Government debt financing, control of credit for so-called speculative purposes, and all qualitative credit considerations. In my view, if the Federal Reserve does an adequate job of

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8/ Theodore Morgan, "The Theory of Error in Centrally-Directed Economic Systems", The Quarterly Journal of Economics, August 1964, pp. 395-419.

economic stabilization, market forces will take care of these factors in a satisfactory manner. Nominal interest rates are not an appropriate monetary target, since Central Bank action may cause perverse movements in rates. In other words, Central Bank expansive actions designed to lower rates may cause them to decline initially but to rise over the longer-run.

Since we cannot readily separate day to day from longer-run forces it is apparent to me that day to day money market rate movements should be ignored in Central Bank actions. I believe that market forces can do a better job of smoothing out daily fluctuations in interest rates than can be done by the Federal Reserve System.

Control of speculation is not an appropriate objective for monetary action. The influence of speculators on economic activity has been greatly overemphasized. Rather than speculators causing the boom and bust of the late 1920's and early 1930's, I suggest a close look at the course of the stock of money. Speculators may have some short-run impact on common stock prices, but the main line of causation is not from stock prices to economic activity; it is rather from economic activity to expected corporate earnings to stock prices.

Similarly, monetary policy should be made independent of most balance of payments considerations. Our domestic economy is too important to impair its functioning in any way in order to achieve some specified balance of payments level or to maintain some specified exchange rate. Other means are available by which the balance can be altered with no damage to the domestic economy. I suggest some type of flexibility in exchange rates as the appropriate answer when relative values of national currencies change.

Other factors in monetary considerations of recent years, such as viability of financial agencies and credit for specific sectors, can likewise be determined by the market place, provided useless interest rate restrictions are removed. Ability to compete and willingness to pay should be of prime concern to those who are in financial business and to those who obtain credit. In this market-determined manner welfare will be maximized.

In my view the economy is basically stable and resilient. Most instability is caused by Government actions; thus a prime concern of policy makers is to avoid unsettling actions rather than attempts to correct assumed imbalances in specific sectors or to achieve ideal conditions.

The Federal Reserve is eminently qualified to control monetary aggregates. There is little doubt of its ability to do this job and by doing so it can prevent major recessions and major inflations. I have doubts concerning the ability of the Federal Reserve to fine tune the economy. It can offset major and longer-run swings caused by exogenous factors, but perhaps we should be content with the smaller economic recessions and expansions. I believe that the monetary authorities can do this modest job of economic stabilization by controlling the stock of money. If it is determined after an earnest effort is made that the stock of money cannot be controlled within an acceptable range, I suggest either the monetary base or bank credit (absent Regulation Q) as an acceptable substitute.

Furthermore, I suggest that all secrecy be eliminated and psychological reactions of the public be ignored in conducting monetary affairs. The so-called "hidden hand view" holds that Central Bank actions can only be effective if the public is ignorant of them. It may be assumed that formulating monetary policy in secrecy is desirable from the monetary authorities' viewpoint on the ground that the public would be unable to question the wisdom of the action. In my view, however, the proceedings of each FOMC meeting should be released to the public as soon as possible after each meeting. The release should be concise and in language that the public can understand. If this is accomplished, the actions to be taken will influence expectations rather than the reverse. These proposals will provide the public with a means for testing stabilization policies and actions while they are being formulated. They conform to the democratic axiom that monetary business is Government business and Government business is the public's business.