Central Banking in a Time of Stress*

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The past year has been a difficult one for monetary policy, both at home and abroad. It began with the Federal Reserve seeking to restrain a boom, while hoping that the Congress would soon extend a helping hand by enacting a tax increase. The Federal Government had been running a huge budget deficit, and its financing severely limited the room for maneuver for monetary policy. Internationally, we had to deal with the aftermath of the sterling devaluation, a rush for gold that verged on panic, then a heavy blow at the French franc two months later. Meanwhile, our own trade balance was deteriorating badly, chiefly as a direct result of the inflation at home.

A major development of the past year was, of course, the enactment of the tax surcharge and expenditure control bill. The initial fears of "overkill", as well as the hopes of a prompt moderation of excessive demand, did not survive for long. The subsequent inflationary developments and expectations have served to emphasize the need for fiscal restraint. Without the shift from a budget deficit of more than $25 billion in the last fiscal year to approximate balance this year, a shift aided substantially by the tax surcharge and expenditure restraints, it is difficult to imagine what would have developed. For that reason, I would like to commend all those bankers who worked tirelessly for this fiscal policy measure, and who —as much as any group—succeeded in persuading a Congress facing election to increase the tax burden. Bankers, in that effort, were carrying on in their best tradition of civic responsibility.

Monetary policy also had to grapple with the inflationary surge of 1968. During the first half of the year, the rate of growth of bank credit was brought down from the high level of the preceding six months. The demands of the Treasury and other borrowers pushed interest rates up, while the Federal Reserve maintained restraint as the tax bill worked its way through the Congress. After the midyear enactment of fiscal restraint, and the quick response of financial markets to the promise of a lower level of credit demands, the System shifted to accommodate the market's move to lower interest rates. With the benefit of hindsight, we can now regret that too-hasty reaction, for it is clear that the growth of money and credit was excessive in an economy marked by undiminished momentum and powerful inflationary forces. Toward the end of the year, there was an appropriate tightening of policy.

I have merely touched on some of the difficult problems of the past year; it is already clear that there will be more of them to face before 1969 is ended. What I prefer to speak about today, however, is the structure of the Federal Reserve System and its position in our Government, and how these features lend themselves to an effective way of developing answers to these difficult problems. I certainly do not intend to argue that the present structure of the System or its formulation of policy is perfect. But I do wish to examine critically some suggestions for radical change, and to call your attention to some elements of strength in our present arrangements.

All of you, I am sure, know in your own organizations occasions when equally intelligent and concerned men facing the same facts come to different policy conclusions. This happens, of course, as votes are counted at meetings of the Federal Open Market Committee and the Federal Reserve Board, whether the policy problem be one of open market operations, discount rates, or bank mergers. No one has a monopoly of wisdom, and the more able

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minds that can be effectively brought to bear on these difficult questions, the better. A special strength of the System is its regional structure that brings it close to the day-to-day life of the whole country. In the Federal Reserve System we especially recognize the great value of the views of the Reserve Bank directors, developed as they are all around the country and in experience with business conditions and financial markets. In a somewhat narrower context, we in the Reserve Banks are aware how much we owe our directors in their decisions and advice on developing and managing an efficient organization and on introducing new methods and techniques.

The idea is sometimes advanced that it would be desirable to concentrate monetary authority in Washington still further. I would like to point out, however, that such a move would not only reduce the part played by the Reserve Banks in the policy formation process, but might also risk the loss of the valuable participation by the Reserve Bank directors. The member banks have a fine record of electing as directors outstanding businessmen and bankers who contribute both sound judgment and intimate knowledge of the current state of the economy to the formulation of monetary policy. The Federal Reserve Act, of course, requires these elected directors—together with other leaders of the community appointed as directors by the Board of Governors—to establish, or reestablish, the discount rate every two weeks. Their action, as you know, is subject to the approval of the Board of Governors, but it seems to me clear that there is an advantage in having discount rate action reflect these combined judgments. Although I probably do not have to tell you so, I must note at this point that the directors deliberate and vote in the broad public interest, whatever their positions in private life.

At every meeting the directors express views on business and credit conditions that are useful to each Reserve Bank president at meetings of the Federal Open Market Committee. I cannot exaggerate the value of the collective judgment of the Reserve Bank directors, expressed as they carry out the responsibilities imposed on them by the Congress. And it seems to me most unlikely that we could continue to attract men of the same high quality if they were to be deprived of a meaningful role in formulating monetary policy.

Another suggestion advanced in recent years is that discretionary judgment with respect to monetary policy is undesirable. Instead, it is argued, there ought to be a fixed rule that would guide the monetary authorities. Under this approach the stock of money would be increased by a uniform percentage each quarter or month. I certainly believe that monetary policy can and should be improved and that its record during the past year has been something less than perfect. But I am not persuaded that we should aim at a fixed percentage growth in the money supply month in and month out regardless of what else is going on in the economy: whether Federal spending is rising rapidly or slowly, whether business capital spending is lively or sluggish, whether labor is in short supply or abundantly available, and whether price increases are negligible or staggeringly large. Moreover, in some circumstances steady growth in the money stock would, in my judgment, entail wild gyrations in interest rates and financial values that could threaten economic stability. I cannot refrain from noting also that advocates of a fixed rule with respect to money have reached no agreement either as to the definition of money or as to the appropriate growth rate of money, however defined.

Turning now to the coordination of System policies with other Government measures, we in the Federal Reserve like to emphasize that the System is not independent *of* the Government, but independent *within* the Government. Naturally, the System is responsible to, and must be responsive to, the Congress, from which all its powers derive. But there is, and there should continue to be, close and frequent consultation with the Administration, especially such bodies as the Treasury Department and the Council of Economic Advisers. The public interest requires the frankest exchange of information and views. In the final analysis, the Federal Reserve must be able to determine monetary policy free from the day-to-day pressure of partisan politics, and the structure of the System helps to attain this end.

I should like to turn now to the area of the System's relations with its member banks. The fact is, of course, that any monetary policy to be effective must work on and through banks. The Federal Reserve can do a great deal just by its control of the cash reserves of the banking system. But it can do a great deal more, and do it more effectively, if banks understand and support its policy. It is not easy, on the face of it, for bankers to approve a policy that restrains their ability to extend credit when interest rates are high. Nonetheless, bankers generally do support such a policy if they are persuaded that it is in the country's best long-run interest, because they then see that it is in their interest as well. Indeed, I was impressed last year with the large number of bankers who criticized the Federal Reserve because it was not still tougher on credit expansion.

It is not easy, to take another example, to support a voluntary program that requests an actual reduction in profitable loans to creditworthy foreign borrowers, risking a loss not only of today's earnings but a handicap in developing future attractive business. Yet bankers have supported this policy, and I hope will continue to do so as long as the need is so urgent, for a strong dollar is in their best long-run interest, as it is in every American's. I believe that one reason for wide support among bankers for policies such as these is the structural relationship between member banks and the Federal Reserve, and the channel of communication which that relationship provides.

I am aware that from time to time some matters come to the fore on which there may be honest differences of opinion. Bankers rightfully feel free to criticize Federal Reserve actions, in both the regulatory and monetary policy fields. Generally, the criticism is constructive, reflecting an active banker participation in the discussion of what is good for the economy and the nation. Not infrequently the criticism is deserved as well and has helped to bring about improvements. For example, there has been a growing feeling that inequitable treatment has developed as between national banks and state-chartered members; one such inequality related to the establishment of operating subsidiaries. Recently the Federal Reserve Board withdrew its objection to the establishment of bank subsidiaries to conduct activities that may be handled more effectively in this way than as a department of the bank itself. This, of course, applies only where state law permits the use of such subsidiaries, as it does in New York State. Progress in eliminating such inequalities and in coping with other problems may not have been as swift or on as broad a front as some of us may wish, but progress is being made and, I hope, will continue to be made. The best way to foster such progress is for you, as bankers, to maintain your interest and participation in System affairs and to let us have your suggestions for improvement.

The Federal Reserve, as I have indicated, is aware of these problems and is seeking ways to eliminate many of the causes of dissatisfaction. We have, as you know, completed a comprehenive study of the discount mechanism on which your views were solicited. A primary purpose of the proposed changes in discount administration is to make the privilege of membership more useful to banks. The System has recently organized a vigorous effort to focus upon some of the supervisory matters which may give rise to dissatisfaction by bankers. Perhaps I should mention, too, that we are at the moment studying closely the implications of the blossoming of one-bank holding companies. With these efforts as evidence, I can assure you that the System is concerned about these supervisory matters and is moving steadily toward improvement.

I have devoted some time to questions about the structure and the policy-making methods of the Federal Reserve System because I think these matters are of substantial and lasting importance. But they take on added significance at this time when our economy and our banking system are being subjected to serious inflationary pressures that distort their effective working. Credit demands are high because of inflation, but the System is trying to limit the growth of bank credit for the same reason. Banks are being pinched by the Regulation Q ceiling, which causes funds they might otherwise attract to be diverted to marketable instruments yielding more than CD's can. Yet, the stubborn fact is that inflation must be resisted and that monetary policy must be in the front line. One can also admit, in this connection, that even the temporary period of "accommodation" during last summer has made our present problems more difficult.

As we look ahead, I still believe we can count on last year's fiscal measures, now supplemented by the increase in the social security tax, to cool down our overheated economy somewhat. We can also look forward to a reduction of Treasury debt between mid-March and June of some $8 billion, in marked contrast to the experience of last spring. Nevertheless, there will surely be a long and arduous way to go before we return to a satisfactory degree of price stability. Yet such a return is essential, not only for the health of our economy at home but for the preservation of confidence in the dollar abroad. It is impossible to repeat too often the warning that continued inflation distorts business judgments on policies involving investment in plant and equipment or in inventories, on wage and price policies, and that decisions that turn out to be unsound and unsustainable will make the necessary correction so much the more painful. I am deeply disturbed, therefore, by the prevalence of inflationary psychology as evidenced by excessive speculation in commodity, security, and real estate markets.

While it is illusory to suppose that we can somehow squeeze all the inflation out of the economy in a few short months, or that the necessary adjustments will be painless for everybody, it is nonetheless true that a continued and successful effort is essential. The alternative, demonstrated again and again in other countries that have had to adopt harsh measures of austerity, is surely less attractive; the problem does not get easier to grapple with if it is pushed away into the future.

It may also be worth reminding ourselves what it is we are trying to achieve. At home, we ought to aim at a gradual reduction in the rate of price inflation, and to do so with a minimum rise in overall unemployment. To reduce the rate of price inflation to 2 percent a year might be a practicable interim goal. To those who fear that this might mean an excessive rise in unemployment, I would point out that at present we face a situation of extreme labor scarcity in most parts of the country, combined with a serious unemployment problem in certain fields, and especially with respect to the nonwhite population. I would hope that we could make continued progress in cutting unemployment in these special areas, while at the same time moderating the more general situation of extreme labor shortage. What we should seek now is a better balance between production and aggregate demand; monetary and fiscal policies can help greatly to achieve that balance. If we do so, we will be mounting a successful attack on the discouraging outlook that now confronts those savers who provide the capital for economic growth by putting their funds in thrift accounts or bonds. We will also be restoring our international trade surplus, largely by reducing the recent unsustainable surge in imports; that improvement, in turn, will strengthen the international monetary structure in which the dollar is the keystone.

This formidable task cannot be accomplished by Government fiscal policy and Federal Reserve monetary measures alone. It needs the cooperation of management and labor, and indeed of all elements in the economy. I have tried to suggest that in banking we have developed a framework in which such cooperation has worked effectively. You, as bankers, advising your corporate and individual customers, can do much to extend that cooperation by fostering understanding during the difficult months ahead as we try to slow down the economy's unsustainable pace to a growth rate that will produce greater real gains for all of us over the long run.