Central Banking in the Economy Today

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I would like to talk today about the central bank and the environment in which it must operate to affect the course of the economy. While I will naturally focus on the Federal Reserve, central banks in other countries face similar challenges and are subject to similar constraints. It may be particularly timely to review these matters in view of the very uncertain economic outlook for 1974, and the problems that this uncertainty poses for monetary policy.

Painted with very broad strokes, the economic picture of the last quarter century or so is quite satisfactory. Never before had this country or other developed economies escaped serious depression for so long. The recessions that were experienced were, historically, mild and short in duration. Until the past few years, our record of inflation was also encouraging; from 1951 to 1965, for example, consumer prices rose less than 1½ percent a year on average. For the past eight years, however, we have been grappling with a stubborn and distressing rate of inflation; averaging over 4 percent a year and exceeding 8 percent last year, it has distorted spending and investing, borrowing and lending, decisions. This inflation is not easily stopped, as we have learned from a mini-recession in 1967 and a year's recession in 1970.

Just as the record of expansion since World War II may point up the capability of the Federal Reserve to contribute to satisfactory economic performance, the experience with inflation since 1965 illustrates some of the limitations of monetary policy. First, throughout most of this period, private demand was strong and fiscal policy, stimulative. In the fiscal years 1971 to 1973, for example, the Federal budget deficit totaled $60.5 billion. As the credit crunch of 1966 illustrated, in the absence of fiscal restraint a restrictive monetary policy can be pushed only so far before the financial system becomes seriously strained. Second, once wages and prices rose, they were validated by contract and price practices, and they resisted decline, even when total demand slackened. Third, in 1973, the second of the dollar devaluations resulted in increased foreign demand for our goods just as bottlenecks in the expanding economy began to appear. Finally, incomes policy, which had contributed to stabilizing prices in 1971 and 1972, became ineffective in the overheated environment of 1973. Thus, appropriate fiscal and incomes policies are important conditions for monetary policy to be effective.

Now, I do not want you to think that I am commenting on the difficulties that confront the Federal Reserve in dealing with economic problems as a defense against criticism of our mistakes, or to seek sympathy for those of us with the responsibility for making policy. It is rather that I believe that a better understanding of what a central bank can and cannot do will guard against unrealistic expectations—and consequent disappointment. Moreover, better understanding may well produce more useful criticism that could help the Federal Reserve to improve its performance.

To begin with, it's obvious that any group—whether in the Congress, the Administration, or the Federal Reserve—required to make decisions that will affect the economy in the future must formulate some idea of how the economy is going to evolve in the months ahead. For the Federal Government's budget, that time period is a year and a half ahead or more. We have just had a timely reminder

—at a recent meeting in this city, attended by some of the country's foremost economists—that the art of forecasting is still an extremely difficult one and that nobody is willing or able to claim adequate foresight. Although the art has certainly made progress in recent decades as our economic understanding has been enhanced, as strides have been made in quantifying variables and constructing econometric models, and as judgment has improved, it still has far to go.

Nevertheless, economic policy makers must do their best to forecast the conditions they hope to affect. At this point, then, we can say that a central bank must make a forecast taking into account all other government policies, and of course it must review this forecast frequently and adjust its policies as that may become desirable. The central bank must then decide how to exert its influence on money and credit, and how vigorously. For some students of central banking policy this task does not seem to pose any problem: just increase the money supply by, say, 6 percent a year or ½ percent a month. This seems to be an appealingly simple solution. But, in my view, an effective monetary policy cannot be achieved by such a simple—and simplistic—formula. As you probably know, a large majority in the Federal Reserve is very reluctant to accept the notion that the rate of growth in bank credit, and total credit, or volatile fluctuations in interest rates, or in velocity, can be safely disregarded in such a narrow focus on any monetary aggregate. And, even if such an approach were desirable, it presumes a much greater degree of statistical knowledge, and a greater ability to control the monetary aggregates in the short run, than exists.

In this regard, I am very much concerned about the adverse impact of the present system of reserve requirements on our ability to control money and credit. In today's environment, effective monetary control requires that the reserves of all institutions offering payments services come under the direct influence of the Federal Reserve. Until this is accomplished, our monetary and credit control efforts will be less precise than they can, or should, be. Moreover, the present system imposes a heavier reserve burden on Federal Reserve member banks than on nonmembers, and fear of aggravating member banks' competitive disadvantage can inhibit the use of reserve requirement changes for control purposes. Thus, I am convinced that we face a continuing gradual weakening of our ability to control money and bank credit so long as some banks have the option of not holding their reserves in a form that comes under the direct influence of the Federal Reserve. These considerations have led me to the firm conclusion that reserve requirements on demand deposits should be similar for both member and nonmember banks. Indeed, it is anomalous that the United States is the only major country in which banks enjoy the option of choosing *not* to adhere to the central bank's reserve regulations.

With respect to nonmember banks, I should also note that we need more comprehensive and timely deposit data from these banks for monetary control purposes. Normally we have gotten deposit figures from nonmember banks for only two days a year; that is, for the June and December call dates. In addition, these figures are available only with a very long lag. Thus, we have no current information on nonmember bank deposits to feed into the monetary-policy process. This has been a serious limitation in recent years when nonmember bank deposits have been growing more rapidly than expected. The June 1972 call report, for example, indicated that nonmember bank demand deposits were $1.8 billion higher than expected, which was the largest such revision on record. Unfortunately, we were not aware of the size of this revision until the end of the year. We are still not sure what changes will be made in 1973's numbers, but, in any case, it seems clear that better nonmember-bank deposit data are needed to enhance overall monetary control.

Apart from the statistical and other limits on our ability to control the monetary aggregates within narrow limits of tolerance in short periods of time, the very attempt to do so would in all likelihood result in wide fluctuations in interest rates. Gyrations in interest rates and in prices of fixed-income securities disrupt financial markets and the decision-making process of market participants. Yet it is in and through these financial markets that the central bank must carry out policy decisions. The basic operating premise of the central bank's open market operations is that they must be conducted in effective, viable financial markets. The need for vigorous markets, capable of absorbing and transmitting the effects of expected and unexpected developments, does not mean the central bank must protect, much less promote the interest of, the participating institutions. It does, however, mean that those committing their capital in the market must be confident that they will not be exposed to unduly violent fluctuations caused by actions of the central bank. Moreover, any suspicion of erratic conduct by the monetary authorities would cause an apprehensive withdrawal of savers and investors that would make it difficult for private and governmental borrowers to conduct financing operations.

Any such interruption of financial flows to the business or consumer sectors would have an adverse impact on production and employment. But over and above such financial effects, uncertainty about the central bank's operations and intentions, resulting from wide short-run

fluctuations in interest rates, may well have a negative effect on business confidence and spending. There is, in short, a real cost to interest rate instability that we cannot ignore in formulating and implementing policy.

Please do not misunderstand me; I am referring here only to the wide gyrations in interest rates that are likely to result from any attempt to maintain steady short-run growth of the monetary aggregates. Longer run movements in interest rates in response to policy changes and developments in the private sector have, of course, important equilibrating and allocative effects on the economy. Such rate movements are obviously meaningful, and are part of the process of transmitting monetary policy changes to the economy. It would be just as bad to try to pursue policies that avoid significant movements in interest rates as to follow policies that lead to very sharp short-term fluctuations in rates. In this respect, I am in full accord with the Federal Reserve move toward greater reliance on interest rates in free markets than on direct controls, such as certificate of deposit (CD) ceiling rates, in the monetary-control process.

Just as the central bank must earn and keep the confidence of financial markets and institutions in its integrity, its competence, and its awareness of present and impending developments, so it must also earn the confidence of the Government, in our case principally the Treasury and the Congressional committees concerned with banking and with the economy. A former Governor of the Bank of England, Lord Cobbold, reflecting on his service in that position, concluded that "After its relationship with Government, which is fundamental," the central bank's "most important concern" is with the banking and financial systems. "One of its first duties", he said, "is to interpret Government thinking to the financial markets and market thinking to the Government. A central bank which is out of touch with its own financial community and does not enjoy their confidence can never be doing its job properly." He then noted that "confidence and praise are two quite different things".

There are clearly major differences between the role in Government of the Federal Reserve and the Bank of England. However, the Federal Reserve Bank of New York —as the operating arm of the System in the domestic money market and of the System and the Treasury in the foreign exchange market—is, I believe, well situated to serve as such an intermediary between the Government and the financial community. We have sought to fulfill this role, always recognizing, of course, that the independence of the Federal Reserve within the Government and from the financial community must not be compromised.

As for "confidence and praise", I am certainly not going to argue that central banks should get heaping portions of praise at frequent intervals, any more than Lord Cobbold would. But a goodly measure of confidence is necessary. Perhaps the chief reason for this is the authority entrusted to the central bank to create and issue money, including the high-powered variety called bank reserves that provide the base for a multiple expansion of bank credit and deposits. It is self-evident that the Congress, the Treasury, and all participants in financial markets have a crucial interest in how well the central bank exercises this great authority. By the same token, all of them will review most carefully the monetary authorities' actions and the results, since those actions will affect incomes and market values. For all these reasons, a central bank must always stand ready to explain its objectives and reasoning, and the use it has made of its instruments. This is particularly true in our country with respect to the Congress, which has delegated its constitutional monetary power to the Federal Reserve.

In the past year we have been confronted with a new problem for monetary policy as the shortages associated with a cyclical peak have been aggravated by a worldwide boom and the reduction in oil supplies. Even before the cutback of oil output and the embargo on shipments to the United States by several large producers in the Middle East, it was becoming apparent that our economy faced a year of much less growth than in 1972 or 1973, when real output rose about 6 percent a year. During 1973 it became increasingly clear—as has often been the case in the past—that we had reached effective capacity for many materials; there were more and more widespread shortages and delays in delivery, larger and larger backlogs of unfilled orders. It was also clear that a good deal of time was going to be required to develop additional capacity.

This cyclical-capacity problem was exacerbated in 1973 by worldwide boom conditions. During most of the period from the end of World War II to last year, the makers of economic policy for the nation had to focus on how fiscal and monetary policies should affect aggregate demand. They could generally assume that an adequate supply of goods and services would be forthcoming, perhaps in response to a higher price, if not at home then from abroad. But one can no longer make that assumption, either knowingly or unconsciously. The coincidence of excess demand, both at home and abroad, in 1973 was unique in the postwar period and meant that we could no longer rely on the rest of the world to fill the gap between supply and demand in this country. In this setting, the devaluation of the dollar, and the encouragement it gave to exports from this country, added to our supply

problem. More recently, this problem has been further aggravated by the oil embargo. Thus, we are facing conditions today quite unlike any of the past quarter century, not merely because of a shortage of petroleum whose extent we cannot even now determine with any precision. There is, in fact, little the central bank can do to ease such supply problems in the short run; as Chairman Burns pointed out, the problem is a shortage of oil, not of money. The central bank can, however, seek to forestall any cumulative downswing in the economy that might result from the oil shortage.

To this point, I have tried to sketch what seem to me some of the major elements shaping the capabilities and limitations of central bank policy, drawing largely on our experiences in the United States, but implying that similar conditions exist in other developed countries. Clearly, I would not wish to conclude without some reference to the world monetary system and the flows of trade, investment, and other international transactions that affect all central banks.

On the international financial side, we have witnessed over the last several years a breakdown of the Bretton Woods system. World trade and investment have nevertheless continued to expand, and some would construe this experience as a vindication of those who have long advocated floating exchange rates and as a repudiation of earlier fears by central bankers, such as myself, that floating rates would not work. I would view the recent experience quite differently.

During the past year it has become evident that no large country is prepared to allow the external value of its currency to fluctuate without limit in response to market forces. To do so is to invite speculative aberrations which may carry exchange rates to levels that are inconsistent with balance-of-payments equilibrium. Moreover, undue variations in exchange rates can have harmful domestic effects on the economic life of every country, large and small. As we have seen in the United States this past year, such rate changes unnecessarily exacerbate inflationary pressures in countries whose currencies depreciate well beyond longer run equilibrium levels. They can also distort the allocation of real resources into a pattern not warranted by underlying economic forces. Thus, for both domestic and international reasons most governments have found it desirable to limit exchange rate fluctuations through periodic official intervention or through controls on trade or payments.

In fact, we have not really had freely floating rates; the world financial system has developed into a mixed arrangement of fixed and managed rates, involving exchange-market intervention by the major central banks of about $30 billion equivalent since last March when the markets were reopened. In this connection, I believe that the resumption of Federal Reserve operations in the foreign exchange markets since last July helped to create conditions in which the improvement in our balance of payments was able to be reflected in the subsequent recovery of the dollar. Such operations will provide an essential safeguard against unwarranted speculation in the future.

It is also evident that exchange rate changes are a matter of international concern, since any exchange rate change inevitably entails variations in the exchange rates of other countries and may introduce new problems in the management of other economies. Thus, the determination of exchange rates under virtually any regime involves a process of international negotiation and conciliation. The Bretton Woods system provided a solution to this problem for many years, but one that placed the United States in a passive role. That role is no longer appropriate, and the need for agreed-upon rules of international conduct is all the more urgent.

The urgent need for close international cooperation is underlined by all of the ramifications of the oil crisis. The impact of the staggering increase in crude oil prices on world trade and payments is of particular concern to central bankers. The resulting jump in payments to the oil-producing countries by the rest of the world will be enormous—some estimates place it in excess of $50 billion this year alone. The readjustment of the world economy to such a major shift can properly take place only on a cooperative basis. If we don't work together we shall all be the losers, the developed and developing countries alike.

In conclusion, I am sure you understand that, despite what I have said about the limits or constraints confronting monetary policy, there is no doubt in my mind of the important influence exerted on the economy by the central bank. It's just that I don't think money is the only thing that matters. You will probably agree that the problems confronting central banks are unusually difficult today. While, in our policy formulation, we can't disregard the possibility of a cumulative downturn that would increase unemployment substantially, inflation has been, and continues to be, the major problem for policy makers. It is difficult to remember a time when the economic outlook was as uncertain as it is today. Supply constraints, not only in petroleum but also in a wide range of basic industrial materials, pose novel and, in the short run at least, largely intractable problems for policy makers. However, I am confident that in time these difficulties will be surmounted, with your cooperation and with that of all of the American people.