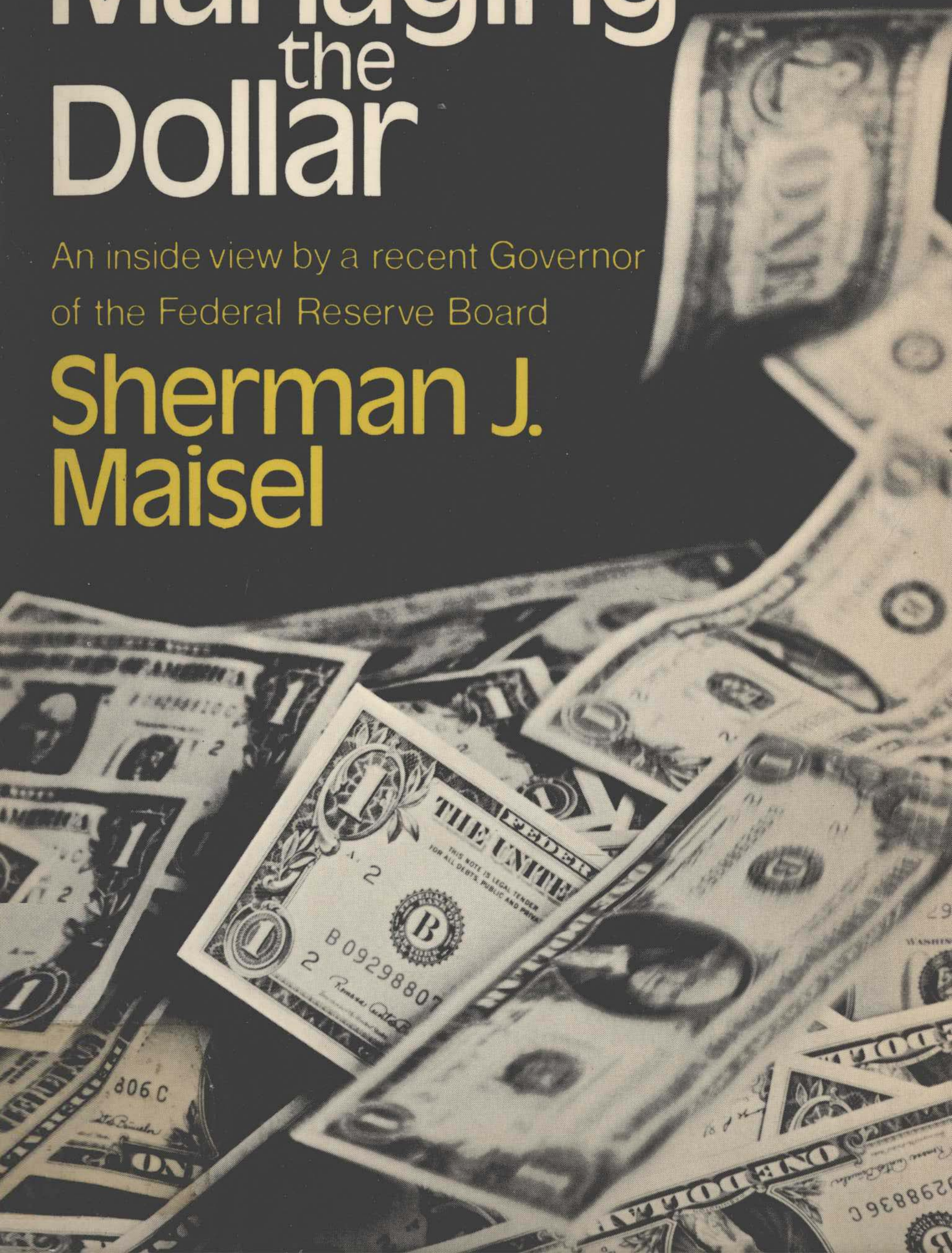
What is monetary policy? How is it made? What does it do? Why does it fail to do what so many want?

Managing the Dollar

An inside view by a recent Governor of the Federal Reserve Board

Sherman J. Maisel



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Preface

MONETARY POLICY is among the most discussed but least understood of all major influences on the economy. The Federal Reserve System is often blamed for everything that goes wrong with the economy—for inflation or deflation, for causing stock prices to sink or to soar, for high or low interest rates, for unemployment, for overprotecting the dollar or for causing its devaluation. The actions of the Fed are the subject of a wealth of articles, books, courses of study, and debate in both financial and academic circles. Yet misunderstandings abound as to what it is trying to do, and why. Although, in comparison with other central banks in the world, the Fed is very open and outspoken, a certain aura of mystery and awe surrounds its operations.

Before my appointment to the Board of Governors of the Federal Reserve System in 1965, I had spent nearly twenty years studying and teaching monetary economics. I thought I understood what the Fed did and how it affected the economy. I soon discovered how little I knew. I also found that the Fed itself, while it had a definite philosophy, had no clear concept of how monetary policy worked. I searched for an official statement of doctrine or an outline of operating procedures. None existed, except at the most general level. I felt from the beginning of my service on the Board that the policy decisions themselves, their

effects on the financial world, and the public's comprehension of the Fed would all be improved if its techniques and operations were more widely understood and were explained in more concrete terms.

While it is true that the more that is known about the workings of an organization, the more criticism it attracts, it is also true that, the better its powers and limitations are understood, the more realistic will be expectations for its performance. My purpose in this book is to promote a realistic conception of the use of monetary policy and how the formulation of it has developed in the past ten years. Those years have been among the most active and interesting in Federal Reserve history, for in this period the full arsenal of the Fed's policies was called upon to meet the crises that confronted the economy and the U.S. central bank. I attempt to show how policy results from an interplay of history, personalities, and doctrine, all reacting to events in the economy and the Washington world. The book is meant for the intelligent layman with an interest in economic affairs, for the college student of economics or business, for the professional analyst. It aims to give a feeling for how the dollar is managed so that they may improve their own judgment of what is happening in financial and money markets.

My background as an economist equipped me to analyze the pressures, procedures, and techniques used to make monetary policies. My membership on the Board of Governors gave me a unique opportunity to do so. The result is an inside view of how policy is actually made. It goes without saying that the impressions and judgments of events and policy making described herein are my own. I am sure that in many cases other members of the Board would interpret identical events very differently. In some situations, a majority might not concur in my analysis and viewpoints —a state of affairs that frequently arose in the course of policy making. These pages present a personal, not an official, view. They describe how I saw monetary policy developing and decisions being made. Clearly, my analysis of what needs to be done and my recommendations for the future are entirely my personal judgments.

The contrast I have drawn between the periods before and after 1966 is much sharper than most within the Federal Reserve

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would accept. Many who were involved in decision making in that earlier period would say that the Fed did an excellent job of gauging the need for monetary policy, given the lack of knowledge that existed. A large body of outside critics disagrees. Since I was not at the Fed at that time, I have little special insight to support either side in that debate. I think, however, that a knowledge of the underlying theory of that era—one which stressed greater or lesser accommodation to the demand for credit—is necessary to an understanding of the controversies surrounding the development of policy in recent years.

My debt is great to many for aid in completing this work. Most of the writing was accomplished while I was a Fellow at the Center for Advanced Study in the Behavioral Sciences. Only those fortunate enough to have had this unique experience can appreciate how much it facilitates the completion of major analytical endeavors. Among the many who have read various drafts of this book, I want to thank for their helpful comments George L. Bach, Frederick A. Breier, Howard Craven, James Duesenberry, Lyle Gramley, Harry Kahn, Thomas Mayer, George Mitchell, Frank O'Brien, Charles Partee, and Merritt Sherman. None of them, of course, is responsible for the errors that may remain. My task was greatly eased by the willing and efficient cooperation of Joan Warmbrunn, who was my secretary, and of my wife, Lucy, who did a great deal of editing and polishing. The same is true for my editors, Donald Lamm and Mary Shuford.

The entire book would not have been possible if the Federal Reserve were not the dynamic, forward-looking institution that it is. It has recognized the need for constant development and has tried to keep an open mind to promote progress.

Managing the Dollar

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CHAPTER ONE

What Went Right? What Went Wrong?

On June 1, 1965, William McChesney Martin, Jr., Chairman of the Federal Reserve Board, spoke before the Commencement Day luncheon of the Columbia University alumni. His speech, "Does Monetary History Repeat Itself?" shook the stock market and the financial community to a degree not experienced in many years. The text was released to the press at noon on that Tuesday; by the time the stock exchange closed, the Dow Jones industrial average had dropped 9.51 points. The next day's front-page article in the New York *Times* was headlined, "Talk by Martin Batters Market." The Dow Jones average fell 19 points the first three days and about 60 points during the three weeks following the speech.

While many other crosscurrents were also at work, the financial press and analysts attributed the severe change in national sentiment to the Martin speech. The national reaction reflected a tremendous respect for Chairman Martin as an acute observer. His fear that some of the excesses of 1929 might be repeating themselves in the current booming market struck a sensitive nerve. It also reflected respect for his position as Chairman of the Federal Reserve Board.

Even though a careful reading of the speech showed that it was primarily a warning against excesses in the private credit and stock markets and a strong plea for international cooperation and

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maintenance of the fixed price for gold at $35 an ounce, observers assumed that the speech was an attack on the Johnson Administration's economic policies. They feared that it signaled a shift in monetary policy from accommodative to restrictive, with a consequent pressure on stock prices. On June 25, the Chairman gave another commencement speech at Rutgers. This speech was optimistic and stated clearly that the Federal Reserve would continue to furnish the funds needed by American business for expansion. Whether by coincidence or not, within a day or so the decline ended; the market shot back up.

June 1, 1965, also marked the end of my first month as a member of the Board of Governors of the Federal Reserve System. I had barely learned the way through the marble halls to my office when I suddenly found myself in the middle of an economic donnybrook. President Lyndon Johnson and Secretary of the Treasury Henry Fowler both felt obliged to respond to Martin, to let the country know that no change in economic policy was contemplated. The Federal Reserve entered a period of tense relations with the Administration.

While no one knew it then, June 1965 was also the last month of the relatively steady economic expansion that had begun in early 1961. The concerns raised by Martin's Columbia speech were shortly overshadowed by other forces. For at least the next eight years (past the end of my term at the Fed) economic events were dominated, or at least strongly influenced, by the surge of spending on the Vietnam War and the private and governmental economic policy reactions which it engendered.

As a result, Martin's question, "Does Monetary History Repeat Itself?" was superseded by an entirely different set of problems. People soon wanted to know why interest rates reached their highest level in over 150 years and remained high, why prices rose at near-record rates even though unemployment was high, why the U.S. dollar was devalued, why wage and price controls were necessary. As it was succinctly put to me by Kenneth Arrow, Nobel laureate and then president of the American Economic Association, "You were in Washington for seven years—what went wrong?" More importantly, however, What did the events of the sixties and early seventies foreshadow for the future? Such questions permit

no simple answers. Yet to plan intelligently for the future and to lessen the chances of still greater inflations, recessions, or depressions, we need to analyze the past.

The Federal Reserve and Monetary Policy

Among those who play a key role in the making of economic policy, we find The Federal Reserve System, the central bank of the United States. To be able to explain and forecast what will happen to the dollar, interest rates, credit, and related economic forces, we must understand how the Federal Reserve works. It both influences and is influenced by movements in the overall economy. It alters monetary policy in reaction to many forces, including instability, financial changes, gold, psychological shifts, uncertainty, and doctrinal debates.

When we speak of monetary policy, we mean the government's influence on the economy through changes in bank reserves, money, and credit. In formulating monetary policy, decision makers at the Federal Reserve select targets for growth in money, for credit, and for the behavior of interest rates, with the objective of helping the nation reach its economic goals. They manipulate bank reserves, discount rates, interest ceilings, and a variety of other monetary instruments in an attempt to hold the economy on a desirable path. When the targets are properly selected and the instruments correctly used, monetary policy helps achieve prosperity. When the targets are wrong or operations ineffective, monetary policy aggravates inflation or unemployment.

For more than fifty years, Federal Reserve decisions have aroused controversy. But, because there is still so little understanding of just what the Fed is trying to do and how it does it, most of such debate has failed to improve decisions. During the seven years I served on the Board many things went wrong; but many other things went right as well. I shall relate some of the important developments and show how new concepts of monetary policy and operations emerged from the trauma of attempts to battle large-scale inflationary pressures.

What Went Right? A Panic Averted

It is perhaps appropriate to start with a major event that went right: that our financial system withstood two tremendous shocks in a two-month period in 1970, the Cambodian invasion and the failure of the Penn Central Railroad, episodes of a kind which previously had led to financial panics and crises.

How Depressions Occur

Economists always fear that a shock to the financial structure will become cumulative and lead to drastic contractions in output and jobs. Some of the worst depressions in United States history have followed liquidity squeezes. In 1873, 1893, 1907, and 1933 the inability of banks to obtain reserves led to major financial panics. There is almost unanimous agreement that a primary reason for central banks to exist is their ability and duty to intervene in such situations to forestall a cumulative monetary contraction.

No matter how a recession or depression starts, it can be greatly exacerbated by monetary events. Spending and output depend on a smooth flow of money and credit. If this flow becomes erratic, income and jobs disappear. Such chains of events can easily be recognized in the past. An occurrence such as the failure of a bank or a large debtor raises questions as to the safety of existing credit arrangements. Creditors and debtors reexamine their positions. They decide that it would be safer to be more liquid, that is, to have more cash on hand in case they have to make unexpected payments or fail to receive expected inflows of money. But the attempt of everyone to become more liquid is self-defeating, as can be illustrated by one of the most typical depressions caused almost entirely by monetary events: the "Wall Street rich man's panic" of 1907.

In that year, when the Knickerbocker Trust Company failed, even though the economy was basically strong, depositors immediately began to withdraw funds from other banks. These banks had

to call loans to obtain the necessary funds. Interest rates on call money loans leaped to over 70 percent and reached 125 percent in some cases. Banks everywhere scrambled for cash. Within a week, banks in New York could no longer supply currency to their depositors. Instead they began issuing clearing house certificates (scrip issued by the banks against their joint frozen assets through their clearing house). Within two weeks banks throughout the country had suspended cash payments and were also issuing scrip. Loans were called. Interest rates rose. As is typical in such situations, when loans were needed, banks either could not or would not lend. As a result, the damage was not limited to banks. As interest rates rose and loans were called, business confidence evaporated; industrial stock prices fell by 50 percent; business failures rose by 30 percent; national output in 1908 was 10 percent less than in 1907; unemployment jumped from under 2 percent to over 8 percent; the amount of saving and investment fell by over 40 percent. This depression was one of the shortest, but also one of the sharpest and deepest, in history.

The 1970 Crisis

It is because they are aware of how dangerous financial squeezes can be that monetary historians, recognizing the contrast to prior panics, will cite May and June 1970 as most significant, although far from typical, months in the financial world. The decisions of the Federal Reserve Board and the Open Market Committee in these two months illustrate monetary policy at its best. The Fed performed the oldest and most traditional central banking function: acting as a lender of last resort. It forestalled a liquidity squeeze by guaranteeing banks the necessary cash and reserves to meet the demands of their customers. In 1970, the economy experienced a mild controlled recession, but not a disastrous depression such as had followed major shortages of reserves in the past.

Toward the end of 1969 the longest economic expansion in U.S. history had ended. The fact that the growth rate of money and credit had deliberately been held well below that of spending was one of the causes of the downturn. Scarce credit led to one of the highest interest-rate periods in history. Early in 1970, however, the

Fed relaxed monetary policy. Reserves and money were expanding at a moderate pace. Short-term interest rates were declining. Long-term rates were stable, but at very high levels.

Then, in fairly rapid succession, came events that altered the entire financial picture. The credit markets were thrown into a panic when, on April 30, news broke that United States forces in Vietnam had extended the war into Cambodia. This was followed by the shootings at Kent State University and a major eruption of protest and strife on campuses and in cities throughout the country. And, on June 21, the Penn Central Railroad filed in federal court for a reorganization under the Federal Bankruptcy Act. Together these events threatened a major liquidity crisis. Each situation struck at a somewhat different part of the financial structure, however. Cambodia and Kent State together menaced security markets and institutions dependent on security values. Plummeting stock prices deepened gloom and uncertainty. The Penn Central collapse then threatened a major source of funds for the nation's large corporations.

In the sixteen months following its peak in December 1968, the stock market had fallen by 25 percent. It fell another 10 to 15 percent in May 1970. Long-term interest rates had reached record highs at the turn of the year; the Cambodia invasion saw them shoot up again. Financial problems were exacerbated by the fact that the news of the expansion of the war hit in the midst of a delicate Treasury financing. The markets would have been completely demoralized if the Federal Reserve and the Treasury had not come to their support with several billions of dollars.

Falling security prices meant higher interest rates. Hardest hit by declining values was the investment community; some of the country's largest investment bankers and brokerage firms became insolvent. Large contractions in net worth threatened the stability of other financial institutions as well, including savings and loan associations, mutual funds, and a billion-dollar bank (the Bank of the Commonwealth in Detroit, a city which had been a center of major troubles in the Great Depression).

The history of previous financial panics indicated that, if repeated, banks, individuals, and corporations would all attempt to become more liquid, they would want to hold as much money as

possible to insure themselves adequate cash and guaranteed solvency; they would dump securities in favor of money; interest rates would rise and security prices fall; loans would be called; net assets would be wiped out. Such a rush to hold money and other liquid assets appeared to be in progress in May, with the demand for liquidity surging. If the Federal Reserve failed to meet the demand by increasing the supply of money available, a true monetary crisis could develop. Even if a crisis did not occur, a failure to meet the demand would have unfortunate effects on output and employment, since available money would not be spent, but would be hoarded or used for improving liquidity instead. Demand for goods and services would fall.

The Federal Reserve Response

Alerted by previous experience, the Fed did not stand by to watch a financial panic develop. Although wracked by a strong internal debate, in May the System furnished the reserves necessary to stabilize financial markets (see pages 37–41). While the probability of a true liquidity crisis might not have been great, as a central bank the Fed had a primary duty to assure that a crisis did not actually occur. Business and consumer confidence was deteriorating; the Fed could help support the economy by attending to its liquidity needs.

The money and credit added calmed the markets upset by Cambodia and Kent State temporarily. Then the second crisis threatened on Sunday, June 21, when the officers of the Penn Central Railroad filed for a reorganization. The Federal Reserve was greatly concerned because this failure jeopardized a major credit market—that for commercial paper. Commercial paper is securities sold by borrowers to lenders with very short terms, from 1 to 270 days. Borrowers generally hold commitments from their bank for funds to pay off loans coming due if the lender decides not to renew, or roll over, the loan through commercial paper. The firms issuing commercial paper (the borrowers) have prime financial ratings, and much of the paper is sold through reputable underwriters. Although most of the nation has never heard of the commercial paper market, from 1965 to May 1970 the amount being

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