# UNITED STATES MONETARY POLICY

Revised Edition

Edited by Neil H. Jacoby

THE AMERICAN ASSEMBLY

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Neil H. Jacoby

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# Preface

This is the second edition, revised, of *United States Monetary Policy*. Under the editorship of Dr. Neil H. Jacoby of the University of California (Los Angeles), the chapters that follow were written originally as background reading for a series of American Assemblies on monetary policy. The first of these meetings was the Fourteenth American Assembly, held at Arden House, the Harriman (N.Y.) campus of Columbia University, in October, 1958. Three other Assemblies took place in 1959, with the cooperation of Duke University, Town Hall of Los Angeles, and Southern Methodist University. Since 1958, this volume has also been used extensively in college and university courses and by the general reading public.

The opinions found herein are those of the authors and do not necessarily represent the views of The American Assembly or the American Bankers' Association, who generously contributed to the financing of this edition.

The American Assembly

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# Introduction: Contemporary Monetary Issues[1]

*NEIL H. JACOBY*

Six years have passed since *United States Monetary Policy* was published in 1958. That volume was directed to a general audience. The papers it contained, all by respected professional economists, were intended to define the principal issues of monetary policy, to weigh alternative solutions, and to provide laymen with the essential knowledge needed for intelligent discussion of monetary issues in the American economy. The book was designed to fill a void in existing literature, to lower the barrier to public understanding of the workings of monetary policy in a free, democratic society.

Subsequent events have shown that the 1958 volume was timely, and that it fulfilled its mission. The first edition attained an extraordinarily wide circulation. Moreover, the publication of the volume was succeeded by an unprecedented surge of public interest in monetary matters, leading to a spate of popular and professional literature. Probably, no aspect of American economic policy has been treated in so voluminous a body of literature in so short a time. The only comparable collections are the extensive studies of the Temporary National Economic Committee during the late 1930's, and the "three-foot shelf" of volumes emerging from the work of the National Monetary Commission during the years 1907–12.

Events have thus fully borne out the truth of the opening sentence of the 1958 edition of *United States Monetary Policy*—"The money question is again in the spotlight of public attention."

In his comprehensive 1962 review of the development and status of monetary theory and policy, Professor H. G. Johnson cited no

[1] I am grateful to Karl Brunner and J. Fred Weston for helpful comments upon this essay.

fewer than 129 significant professional economic publications, more than three-fourths of which appeared subsequent to 1958.[2] Since 1958, the United Kingdom and Canada, as well as the United States, have published the results of massive public inquiries into the institutional machinery and the policies of their monetary and credit systems. The Committee on the Working of the Monetary System appointed by the Treasury of the United Kingdom brought forth its Report in August, 1959.[3] In 1961, the Commission on Money and Credit published its Report on *Money and Credit*, the fruit of a three-year intensive study sponsored by the Committee for Economic Development of the United States.[4] This was followed by eighteen volumes of supplementary studies of particular financial industries and monetary policy problems by seventy-five economists whose work had helped to guide the Commission to its conclusions. Even more recently, in 1963, the Royal Commission on Banking and Finance of Canada published its Report, redefining the role of banking institutions and monetary policy in the Canadian economy.[5]

Nor have the legislative and executive branches of the U.S. federal government neglected monetary issues. Extensive hearings have been held in recent times by the Joint Economic Committee of the Congress on the Recommendations of the Commission on Money and Credit. The Senate Finance Committee labored and brought forth a proposed Financial Institutions Act, which later died in the House. In 1963, President Kennedy appointed three committees—on federal credit programs, financial institutions, and pension funds—to study and report upon the CMC proposals.[6] Meanwhile, the Controller of the Currency sponsored and published a series of banking and monetary studies in

[2] H. G. Johnson, "Monetary Theory and Policy," *American Economic Review*, LII, No. 5 (June, 1962), 335–84.

[3] *Report of the Committee on the Working of the Monetary System* (London: H. M. Stationary Office, CMND 827, August, 1959).

[4] Commission on Money and Credit, *Money and Credit* (Englewood Cliffs, N.J.: Prentice-Hall, 1961).

[5] Royal Commission on Banking and Finance, *Report* (Ottawa, 1963).

[6] The reports of the first two committees were analyzed by R. J. Saulnier in *Recent Studies of Our Financial System*. Business Paper No. 9. (Bureau of Business Research, Graduate School of Business, Indiana University, 1964).

commemoration of the centennial of the national banking system.[7] So far, the tangible products of legislative inquiries have been modest; but potentially far-reaching changes in policies of chartering and regulating national banks have been instituted, and shifts in the legislation governing the private financial system appear probable.

Apart from governmental and quasi-public inquiries into monetary matters, the academic community and research foundations have been active in this field during the past half-dozen years. Among the most basic contributions are those of Goldsmith,[8] Gurley and Shaw,[9] Friedman,[10] and Brunner and Meltzer.[11]

In view of this extraordinary spate of literature on many facets of monetary policy during the past six years, why is a second edition of *United States Monetary Policy* necessary? The answer is that nearly all of the recent literature has been either highly technical, or specialized, or not readily accessible to the layman. What the intelligent layman needs is an accurate but intelligible, comprehensive but not encyclopedic, account of monetary policy issues between the covers of one volume. This need is as urgent today as it was in 1958.

Even more important is the fact that, despite the widespread attention given to monetary policy issues by economists, bankers, and statesmen during recent years, many issues remain "moot." Although much progress toward understanding has been made, research has not yet discovered answers to many monetary problems in which one may repose a high degree of confidence. Personal "values" and judgments thus continue to play an important role in the formation of monetary policies. These are the

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7 Deane Carson (ed.), *Banking and Monetary Studies* (Homewood, Ill.: Richard D. Irwin, 1963).

8 Particularly, *Financial Intermediaries in the American Economy* (Princeton, N.J.: Princeton University Press, 1958).

9 Especially, *Money in a Theory of Finance* (Washington, D.C.: The Brookings Institution, 1960).

10 Especially, *A Program for Monetary Stability* (New York: Fordham University Press, 1959); and, with Anna Schwartz, *A Monetary History of the United States, 1867–1960* (Princeton, N.J.: Princeton University Press, 1963).

11 Brunner and Meltzer's extensive work, part of which has appeared in articles, will be published in *Monetary Theory and Monetary Policy* in 1965.

stuff of which public debate and discussion is made in a democratic society.

During most of the post-World War II era (strictly speaking, since the Federal Reserve–Treasury "Accord" of March, 1951), the federal government has relied upon monetary policy as a principal instrument for achieving United States economic goals. The Employment Act of 1946 placed great responsibilities upon the federal government for maintaining a prosperous economy. Americans have come to judge the performance of the economy, and the record of each national administration, by more exacting standards than have ever before been applied. As a people, we insist upon more rapid, better sustained, and more widely shared economic progress than we were accustomed to expect in earlier times. Because monetary policy could be a primary means toward these ends, we naturally expect more of it than we once did. We inquire whether current monetary institutions, processes, and controls are yielding their full potential values in regulating the economy. We wonder whether the monetary concepts that guide the Federal Reserve System's policy have even been adequately formulated and appraised.

Much of the difficulty of questions of monetary policy arises from lamentable gaps in our knowledge of basic monetary relationships. For example: What factors determine the "demand" for money by households or by business enterprises? Is there a stable relationship between the flow of income into a family or its stock of wealth, on the one hand, and the amount of money it desires to hold, on the other? What is the optimal stock of money in the economy under various circumstances? How do nonbank financial institutions influence the behavior of the money supply? What are the rules that should guide the monetary authorities in adjusting the stock of money and credit through time? What are the time lags involved between actions of the monetary authorities and the responses of the economy?

Dependable answers to monetary questions will, of course, require a great deal more fundamental research. But better monetary policy in the future will also require education in and discussion of the monetary facts and relationships discovered by research. Research and education are indispensible to each other.

Education, without the knowledge revealed by research, can be stultifying. Research, unaccompanied by the education that puts new knowledge into action, can be sterile. Our purpose in this volume is educational—to raise the important issues of contemporary monetary policy in a systematic framework, and to bring to bear upon those issues such knowledge as we possess.

In the present chapter we shall refrain from taking a position on monetary issues: That is done by other contributors to this volume. Being free, for the time being, of the annoying responsibility to answer difficult questions may enable us to concentrate attention upon the formulation of monetary issues in ways that put our minds in motion down the right channels. Proceeding on the aphorism that a question well posed is half answered, let us try to set out in an orderly fashion the monetary problems that beset our economy.

## What Is "Monetary Policy"?

First of all, what is meant by "monetary policy"? A little thought makes it evident that the phrase can have both a broad, comprehensive meaning, and also a strict and narrow interpretation.

Broadly speaking, "monetary policy" can be conceived to embrace *all measures undertaken by government or by private enterprises to affect the structure and operation of the financial system of the economy or the supply and use of money by the public.* Such measures include the selection of a monetary standard and the organization and regulation of the central bank, banks of deposit, and nonbank financial institutions. They include the constitution and management of federal lending and loan-insuring agencies, such as those in the Housing and Home Finance System, the Farm Credit System, or the Small Business Administration. In this broad conception, "monetary policy" would also include governmental actions with respect to public expenditures, taxation, and the management of the public debt. Indeed, under an inclusive definition a large part of public economic policy can, without strain, be brought under the broad umbrella of "monetary policy."

A much more restrictive concept of "monetary policy" is, however, customary in American economic writing and thinking. The phrase is ordinarily taken to refer to *the regulation of the supply*

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*and use of money (currency and bank deposits) by the Federal Reserve System.* "Monetary policy" in this narrower sense is concerned with the objectives and instruments of control of money and credit in the hands of the Board of Governors of the Federal Reserve System and the Federal Reserve Banks. It considers all transactions between the central bank, commercial banks, financial intermediaries, and the public that influence the demand for and the supply of money.

In this volume we are concerned primarily with monetary policy in the strict sense. The major features of the U.S. monetary system, such as a currency unit having a fixed amount of gold and a fractional-reserve banking system, will be taken for granted. We shall put to one side such monetary problems as alternative monetary standards, fixed or variable exchange rates with other currencies, 100 per cent reserve banking, international monetary arrangements, and the financial constitution of the domestic economy. We focus attention upon Federal Reserve policies and instrumentalities of monetary management. The *general* instruments include open-market purchases and sales of government securities, discount rates and policies, and adjustments in the ratios of reserves to deposits that member banks in the System are required to maintain in the Federal Reserve Banks of their respective districts. In addition, the System possesses a *selective* instrument of control in its power to fix the terms of stock-market credit. In the past, the System has also exercised selective control over the terms of installment credit to purchase automobiles; and selective control of home mortgage credit has frequently been proposed.

Although monetary policy in the narrower sense can wield a powerful influence upon the economy, it is inescapably connected with U.S. public policies regarding taxation, expenditure, lending and loan insurance, debt management, and international trade and investment. It cannot be formulated or evaluated apart from policies in these other spheres by other important countries as well as our own in an interdependent Free World economy. The connections of monetary policy to these other policies must be understood before any useful conclusions can be reached about the adequacy of the current machinery of monetary management and the principles that should guide its operation.

## A Framework of Monetary Policy Analysis

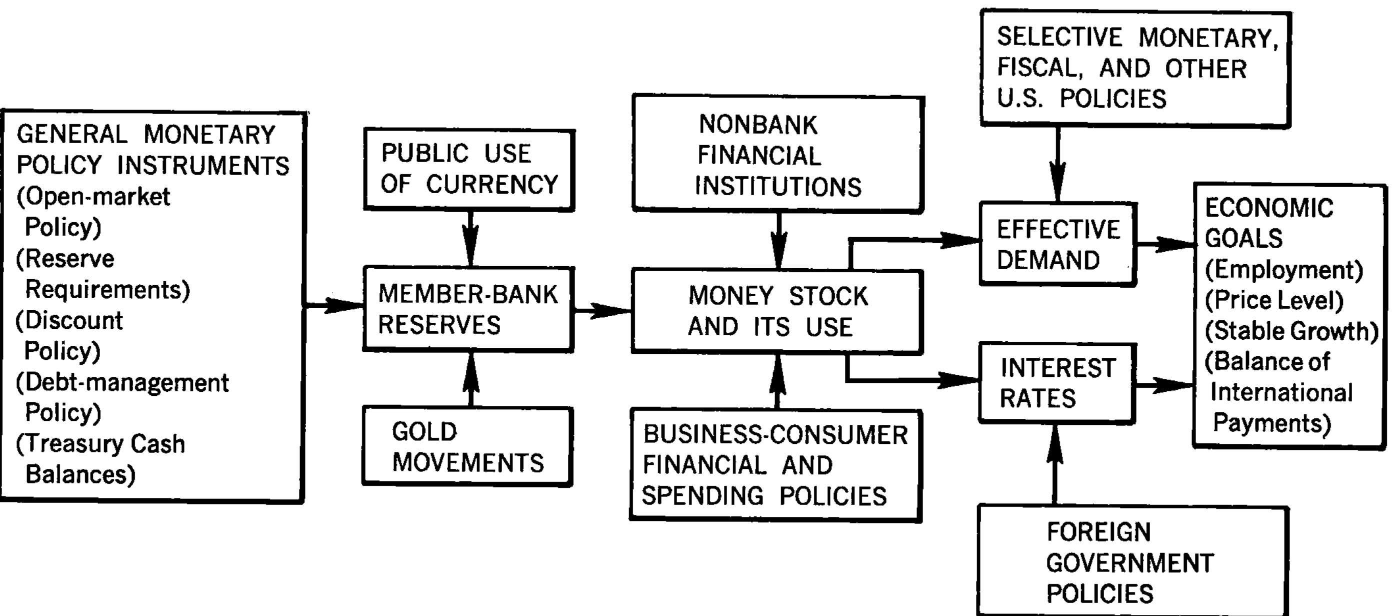
It is helpful to portray in a flow diagram major causal influences, and their interrelationships, which bear upon the performance of the United States economy. Although much oversimplified, Figure 1 shows the main linkages between monetary policy instruments and economic goals, and the stages in this chain of influence at which nonmonetary forces come into play.[12]

Monetary policy produces its effects upon the performance of the economy *indirectly*—by influencing the aggregate amount and composition of effective demand for goods and services and the interest rates charged for investment funds in the financial markets of the nation. But its influence upon aggregate demand and interest rates is, again, indirect, being primarily upon the size of the stock of money held by households, business firms, and nonbank financial institutions. The money stock, in turn, is controlled mainly by the amount of member-bank reserves. Under our fractional-reserve banking principle, member banks of the Federal Reserve System are required to maintain in the Federal Reserve Bank of their district a specific minimum amount, averaging about 15 per cent, of their deposits in cash. An individual bank is able to make additional loans and investments, thereby creating additional demand deposits for the public, only to the extent that its current balance with its Federal Reserve Bank exceeds its legal reserve requirement. However, the customers of any individual bank will check against the deposits created by its loans to them, and these checks will be deposited mainly with other banks, adding to their excess reserves and lending power. If they, too, add to money stock by making additional loans and creating deposits, some of them will flow back as deposits in the original bank. Thus, in theory the banking system as a whole ultimately

[12] Figure 1 is approximate and ignores feed-back effects in a dynamic model. An alternative flow diagram might show *monetary policy variables and the gold stock* determining the *monetary base* (bank reserves plus currency), which, along with the public's division of money balances into deposits and currency and the banks' division of their assets between loans plus investments and reserves, controls the *supply of money*. Money supply, taken jointly with public demand for money and the public's supply of assets to the banks, determines *aggregate demand* and *interest rates*, which, in turn, determines *real output* and *the price level*. Through time, the latter variables feed back influences to the former.

FIGURE 1

FLOW DIAGRAM OF MAJOR MONETARY AND OTHER INFLUENCES UPON UNITED STATES ECONOMIC PERFORMANCE



should be able to add about $7 of money for each additional $1 of reserves. Empirical studies indicate that the actual multiplier is much smaller—between 2.5 and 3.0—which implies that a large fraction of new bank credit spills over into additional currency. By controlling the amount of reserves through open-market operations, discount rates, and legal reserve requirements, the Federal Reserve authorities nonetheless can exert a powerful leverage on the total money supply.

Not only is the influence of general instruments of monetary policy indirect, but it is *partial and incomplete.* At each stage in the chain of causation depicted in Figure 1, other important variables come into play, which are outside the control of the Federal Reserve authorities and which may either magnify or offset the influence of monetary policy. Again, let us start with goals of economic performance, and work backward.

Effective demand for final products of the economy and the interest rates ruling in financial markets are a product not simply of the stock of money (currency and bank deposits) in the hands of the public. They are also determined directly by selective monetary policy instruments, and even more importantly by the taxing, spending, and lending policies of the federal government which bear upon the net spending power of the public.

It should be observed, in this connection, that only *selective* monetary policy instruments, such as Federal Reserve control of the terms on which stock-market credit can be made available to lenders, exert a *direct* influence upon the amount of effective demand for equity securities. Domestic interest rates depend not alone upon Federal Reserve adjustments in the money stock, but also upon the interest rates ruling in the financial markets of major foreign countries with which the United States maintains active economic relations. This greatly complicates the task of formulating monetary policy. It becomes necessary to gear U.S. monetary policies into U.S. fiscal and other policies bearing upon aggregate demand, and also to take into account financial relations of the U.S. economy with the rest of the world and the way in which those relations are being influenced by the policy actions of foreign governments.

To take a familiar example, attainment of high levels of pro-

duction and employment at home may call for U.S. monetary policies conducive to the expansion of effective demand and to the lowering of interest rates. But if the U.S. already has a large deficit in its international balance of payments, a liberal monetary policy may well expand U.S. demand for foreign imports and for foreign investments yielding higher rates of return, thus enlarging the deficit in the U.S. balance of payments beyond prudent levels. In this circumstance, a preferable public policy might be to restrain the growth of credit and to maintain higher money rates by a restrictive monetary policy, while expanding domestic demand through tax reduction and liberal fiscal measures.

The amount of effective demand in the economy is determined not only by the stock of currency and bank deposits held by the public, and by its current flow of money income. It is also influenced by the financial policies of households, business firms, and nonbank financial institutions in using the spending power they possess. These are factors beyond the direct influence of the Federal Reserve authorities. They determine what economists call the "income velocity" of circulation of money. Are the habits, preferences, and financial policies of these different groups of money-users relatively stable through time, so that the Federal Reserve authorities may ignore them in formulating monetary policies? Or do they change with such frequency and unpredictability as to call for major adjustments in monetary policies, and perhaps for equipping the Federal Reserve authorities with new, special powers of control over nonbank financial institutions? In technical language, the basic issue is whether the demand function for money is relatively stable through time. Recent studies support an affirmative answer to this question.

To be more specific, do savings and loan associations, life insurance companies, pension funds, and other financial institutions tend to build up idle money balances under some conditions and to deplete these balances in acquiring investment assets under other conditions, thus introducing a disturbing influence in the rate of use of money? This issue has been debated extensively by economists in recent years.[13] Although the weight of evidence and

[13] Professors Gurley and Shaw have proposed that the main nonbank financial institutions, as well as banks, should be required to maintain

opinion currently favors the view that no special new instruments of control are necessary, the issue is by no means settled.

Moving back another step in Figure 1, it is to be noted that the amount of member-bank reserves is depicted as a function of the general monetary policy instruments. Although it is true that the Federal Reserve authorities can dominate the amount of member-bank reserves available for backing up bank deposits and, under a fractional reserve system, can thereby effectively control the potential stock of money, two important qualifications of their power exist. First, although they can make reserves available to commercial banks by open-market operations, discount policy, or adjustment of legal reserve requirements, they *cannot compel* member banks to expand their loans and deposits. Loan and deposit expansion (and thereby increase in the money stock) depends also upon the willingness of banks to lend and of consumers and business firms to borrow. The power of the Federal Reserve authorities to curtail further expansion of the money stock, or to bring about a reduction in the outstanding stock, is clear enough. Faced with a shortage of reserves, a member bank is obliged to call loans or to sell investments. If the whole banking system is short of reserves, all banks must contract loans and the aggregate amount of deposits and the stock of money will shrink. But the ability of the Federal Reserve System to expand the money supply by augmenting the amount of reserves available to member banks is limited and conditional. Even though the amount of reserves made available to member banks is greatly increased, general pessimistic expectations in the economy may inhibit a recovery in the demand for loans. Thus interest rates may fall to very low levels, as they did during the 1930's. Because the cost of being liquid becomes negligible, a liquidity "trap" may develop, manifested in the presence of large excess reserves in the banking system for extended periods of time. Although the reality of this argument has been questioned, this "asymmetry" in



## Monetary Policy and U.S. Economic Goals

Perhaps the most fundamental issues of monetary policy have to do with its primary purposes. We assume that monetary measures should contribute to the realization of generally accepted national economic purposes, including full employment, steady

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