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THE ROLE OF MONETARY POLICY IN COMBATING DEPRESSION

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Summary

The paper on monetary policy presented by Robert V. Roosa is not available for inclusion in this volume. The main contents of the paper are presented here in a summary prepared by the editor.

The effectiveness of monetary policy in promoting stability, and the means by which it can be most effective, depend upon the phase of the business cycle and upon the nature of the monetary influence at work in the particular cyclical situation.

Five different roles of monetary influence in cyclical fluctuations may be distinguished:

1. Causal, in terms of the aggregate supply of money and credit
2. Causal, in terms of the selective influence of shifts within the distribution of the available volume of credit that create serious distortions in the pattern of demand
3. Accelerating, in the aggregative sense
4. Accelerating, in the selective sense
5. Expediting, or passive, in the sense of "servicing" without either initiating causally or accelerating the effects of other causes

Even in this fifth case, where monetary factors neither cause nor accelerate expansion or contraction, there will be an opportunity to use monetary policy to offset or control the underlying causal influences.

The first case, in which the aggregate supply of bank reserves and money exert a causal influence upon business, is unlikely to be important in the United States any more. Control directed to the volume of bank reserves alone (along with control over the reserve ratio) should be adequate to check any monetary and credit expansion that could threaten to become so large, in the aggregate, as to be an initiating cause of inflation. Conversely, since the only circumstances in which a general shortage of money and credit would precipitate an economic contraction appear to be those in which reserve funds suddenly become inadequate or secondary reserves become frozen, a policy of increasing the volume of reserves could, if pushed far enough soon enough, prevent that potential cause of contraction.

Restraining Excesses during the Boom

Monetary policy can make its main contribution to economic stability by removing or reducing the financial causes of "over-exhilaration" during periods of prosperity or boom.

A "narrow" policy of restraining the growth of total bank reserves by Federal Reserve operations confined to the Treasury bill market would probably be sufficient to limit any tendency for the credit mechanism to accelerate the forces of inflation. However, if the forces of expansion are very strong, the central bank may become instrumental in causing an actual collapse in using reserve requirements to check the inflationary forces. Moreover, so limited a policy will not be able to cope with distortions that may have serious general consequences. And it will be unable to cope with nonmonetary causes of instability in the boom.

A more pervasive and more selective monetary policy will be needed, a policy that will enable the central bank, by direct contact, to maintain varying degrees of pressure in all parts of the capital market. The central bank should be able to exert a restraining influence on the markets for longer-term funds without having to tighten the short-term market so severely as to cause a financial stalemate of some sort. Also it should be possible to direct the influence of monetary policy in such a way as to restrain a tendency for credit factors to accentuate distortion among sectors of the economy—such as, for example, a relative flooding of funds into the mortgage market.

In order to meet these requirements of a restraining policy in booms, the monetary authority should be free to conduct open-market transactions in government securities of various maturities and should not be confined to dealing in bills. Even this broader use of open-market policy may not be enough. The central bank should have stand-by authority to use selective controls in parts of the market where impersonal regulations can be devised and administered.

Cushioning the Upper Turning Point

As the forces of expansion weaken, and the economy enters a plateau, with signs or danger of a decline, there are two things that monetary policy can do.

First, it should prevent financial panic. This is now generally regarded as assured.

Second, it should minimize any financial pressures that might accentuate a tendency toward decline. The most effective way to do this will be to remove from the minds of lenders any expectation of further increase in interest rates and create the expectation of a decline. This change in expectations should extend throughout the maturity structure. It will be most important in the longer maturities, where the fact and expectation of lower interest rates can create the fact and expectation of large appreciation in capital values.

A monetary policy that operates in all parts of the maturity range will be able to achieve the desired results more quickly than operations confined to Treasury bills and without action so extreme as to suggest that the central bank regards the situation as critical.

Resisting a Downswing

If monetary policy has prevented the development of serious credit distortions or excesses on the upswing and at the upper turning point, the causes of a downswing would center in the physical processes in the economy. In this case, monetary policy would have two functions:

1. It should aim to prevent the development within the financial mechanism of cumulative factors that would aggravate the downturn. Concentration on expanding bank reserves by open-market operations in Treasury bills would be relatively ineffective for this purpose; it would be unable to bring about the kind of change in expectations that would help to halt a cumulative acceleration.

2. It should try to work through the monetary and credit mechanism to counter disruptive downward developments in the physical sectors. A state of credit ease, brought about by expansion of bank reserves, may well have important stimulative influence, particularly in the case of borrowers for whom current economic fluctuations are less important than long-range prospects. To assure a wide diffusion of credit ease, without so sharp a reduction of interest rates as

to create havoc among institutional investors, the central bank should be able to inject funds directly into the various segments of the market.

Combating a Cumulative Downswing and Deep Depression

In a cumulative downswing or deep depression the appropriate monetary policy would be one of outright ease, which would have a valuable ameliorative effect. The main responsibility for combating the depression would, however, lie with other measures, notably fiscal policy.

In addition to creating a general condition of credit ease, financial policy can take other steps to limit the enforced, or distress, liquidation of assets and debt. These steps include:

1. Checking the tendency for bank examination standards to become tighter during a depression.

2. Avoiding bank closings and their consequences. Protection against bank closings is already substantially assured by the establishment of Federal Deposit Insurance and the authorization for the Federal Reserve banks to lend on any assets of any bank.

3. Avoiding pressure for banks to liquidate private credits to meet loss of deposits in depression. This is probably taken care of by the large amounts of government securities held by banks and by the widened lending authority of the Federal Reserve banks.

4. Direct lending to nonbank enterprises by the central bank. The amount of such lending is likely to be small. However, the authority and machinery should be kept available to permit some testing of the possibilities of special need during the stages of a downswing.