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The New Uses of Monetary Powers

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TABLE OF CONTENTS

NEW USES OF MONETARY POWERS <i>Hyman P. Minsky</i>	3
PUBLIC ASSISTANCE, FAMILY ALLOWANCES, OR THE NEGATIVE INCOME TAX <i>Joseph J. Klos</i>	16
INTERMODAL COMPETITION IN TRANSPORTATION AND ECONOMIC DEVELOPMENT <i>Robert W. Harbeson</i>	32
DYNAMIC ALLOCATION OF HUMAN RESOURCES IN THE UPPER MIDWEST <i>Dennis J. Dugan</i>	48
A METHOD FOR ALLOCATING STATE AND LOCAL PROPERTY TAXES TO INDUSTRY GROUPS AS APPLIED TO NEBRASKA DATA <i>Theodore W. Roesler and Henry C. Norris</i>	70

THE NEW USES OF MONETARY POWERS*

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INTRODUCTION

Over the past several years United States financial markets have experienced their most serious stresses and strains since the great depression of the 1930's. These stresses and strains have been due to both domestic and international developments. As a result market instruments, institutions, and usages have undergone marked changes, and the Federal Reserve System, as well as the other agencies of the peculiarly decentralized central bank of the United States, have responded by adjusting their operations: monetary powers have been used in new ways.

Some of these new uses of monetary powers will be discussed under two headings:¹ the guidance of the evolution of financial markets and the manipulation of uncertainty. As a result of these new uses, the domain of responsibility of the Federal Reserve and the relation between it and other regulatory agencies need to be reexamined.

Central banking has always been a major determinant of what is known with certainty, what is probable, and what is purely conjectural in financial markets. The evolution and development of central banking has not been solely a reaction to an independently-evolving financial structure, but has been also a determinant of this evolution. A sophisticated central bank has always cast a "wider net" than any narrow legislated or contractual responsibilities. Thus it can be claimed that these new uses are not really new. The context, however, is new: monetary policy operations are now being undertaken in a world where active monetary and fiscal policy is used to "fine tune" the economy and where there is a wide acceptance of the view that this can be accomplished. As a result monetary policy is being carried out without the constraints upon financial

*This is a revised version of a paper read at the Midwest Economics Association, April 19, 1968.

¹I do not claim that the developments I discuss represent all, or even the most significant, recent developments; my knowledge is imperfect and from those I know of I have selected elements which seem to have the greatest relevance to the stability properties of the system and the practice of central banking.

positions and experimentation with new financial market usages that might result from prospects of serious business depressions. That is, fear of the proverbial income and employment "rainy day" is attenuated, and with this attenuation the emphasis on assets to protect against rainy days has decreased.²

Whenever central banks undertake to maintain orderly conditions in financial markets or to be the lenders of last resort, they act upon "confidence" and thus uncertainty; they try to diminish this uncertainty by assuring that particular adverse market conditions cannot happen. The new use of central bank powers as they affect uncertainty is a form of financial brinksmanship. The central bank acts so that the range of "possible" market conditions increases: in particular, market conditions which both generate losses and disrupt financial channels are permitted to develop. That is, instead of acting as an insurer (substituting certainty for uncertainty) central banking has taken on some aspects of a casino (substituting uncertainty for certainty).³

In this paper reference is made to the credit crunch of 1966.⁴ The "crunch" was a miniature financial panic. Effective action by the Federal Reserve and the other financial authorities prevented the escalation of the crunch into a full-fledged money market panic. Nevertheless, the crunch did bring a pause to a runaway investment boom and it did induce some (perhaps transitory) conservatism into portfolios. In retrospect, the crunch was the result of the way in which monetary policy functioned during the expansion of 1960-66. Whether "crunches" should be part of the arsenal of the Federal Reserve, to be induced in appropriate conditions, is a question that needs examination.

THE GUIDANCE OF THE EVOLUTION OF FINANCIAL MARKETS

Two aspects of the evolution of the financial system during the continuing expansion of the 1960's will be discussed. First, the role of certificates of deposit in putting pressure on depository savings

²It may be claimed that the "New Era" of the 1920's was also characterized by confidence in the "new" sophistication of economic policy—in that era the confidence was due to the existence of a "sophisticated" Federal Reserve System.

³Milton Friedman and L. J. Savage. "The Utility Analysis of Choices Involving Risk," *Journal of Political Economy*, Vol. LVI (1948).

⁴I have discussed the crunch and its consequences in two places: "The Crunch and its Aftermath," *Bankers Magazine*, Feb., March, 1968; and "The Crunch of 1966—Model for New Financial Crises," *Trans-action Magazine*, March, 1968.

intermediaries (savings and loan associations and mutual savings banks) and in constraining the Federal Reserve System, especially in the period leading up to the crunch of 1966, will be examined. Then the rapid growth in the volume of commercial paper outstanding since midyear 1966 and the associated changes in bank and bank customer relations will be considered. These developments pose a threat to the "gimmick" used to help ease the pressures on savings intermediaries in 1966 and may require some modifications in Federal Reserve technique.

The major thrust of the argument that follows is that the Federal Reserve should use its monetary powers to guide the evolution of financial markets in directions that are compatible with financial stability in the longer run rather than improvise controls that put out fires but which allow the underlying market situation to remain unchanged.

During the crunch of 1966 interrelations among various elements in the financial system became constraints upon policy. The rise in interest rates on certificates of deposit, combined with the emergence of retail certificates of deposit, posed a threat to the viability of savings and loan associations and mutual savings banks. The mortgage made standard by the reform legislation of the 1930's was an effective constraint upon the use of high interest rates to ration finance for investment.

The financial system is a complex set of linkages. Feedbacks from one market to another are numerous. The market for certificates of deposit, since its emergence in the early 1960's, has always threatened to trigger a run of depositors from savings institutions. The inadequate secondary market and the paucity of price supports for mortgages mean that savings and loan associations and mutual savings banks are always in danger of capital losses when they collectively need to sell out a part of their position. The only meaningful protection for such institutions is to prevent a run-off of their deposit liabilities, i.e., to refinance rather than sell out their position. To do this, however, they must meet market competition day by day; the threat of a run, now called "discrimination," is always present. Thus, one effective constraint upon Federal Reserve policies is the need to maintain interest rates on secure assets available to households in the neighborhood of the rates which savings and loan associations and mutual savings banks can afford to pay.

These savings organizations are heavily invested in long-term

mortgages which reflect historic interest rates. Even though the expected life of a mortgage is shorter than its contractual life, the assets of savings organizations reflect the relatively distant past of the system to a far greater extent than those of commercial banks. Thus, as long as the fully amortized fixed-interest-rate mortgage is the standard, an effective constraint upon the use of interest rate increases to restrain investment demand is the need to keep current interest rates in touch with historic interest rates.

Of course, we do not revalue the assets (of savings and loan associations, mutual savings banks and insurance companies) every time interest rates rise and price their mortgages at market rather than at par. Even though savings institutions may be technically insolvent, a fiction of solvency is maintained by valuing assets at par. If the return on assets is less than the cost of doing business, including the cost of retaining deposits, then, even though the organization can be made to look solvent, its net worth will be decreasing as a result of these running losses. Given the thin equity position of savings organizations, such operating losses cannot be long sustained. Thus the Federal Reserve System is constrained by the structure of financial markets and cannot allow too great a rise in interest rates on retail deposits to take place.

A substitution of fully amortized, long-run, variable-interest-rate mortgages for the present fixed-interest-rate mortgages is necessary if rapid and substantial increases in long-term interest rates are to be consistent with the integrity of savings institutions. For the Federal Reserve to be free to adopt policies which lead to sharp increases in long-term rates, it needs to guide the evolution of mortgages in the direction of the adoption of variable interest rates. This could be accomplished by making variable-interest-rate mortgages eligible for discount, by making the paper of dealers in such mortgages eligible for discount, or by extending Federal insurance only to such mortgages. The political difficulties of moving the specialized government agencies to adopt such an alternative convention for mortgages is an argument against the present decentralized central bank structure.⁶

⁶ Various alternatives to adoption of a variable interest rate mortgage have been suggested. For the entire issue of the good financial society various writings of Henry Simons are still relevant. See his "A Positive Program for Laissez Faire" and "Rules Versus Authorities in Monetary Policy;" both are reprinted in H. Simons, *Economic Policy for a Free Society* (University of Chicago Press, Chicago, Illinois, 1948).

In the mini-crisis of 1966, the various authorities did not face up to the flaw in the financial system due to the standard mortgage. When commercial bank competition for retail-size time deposits threatened the liquidity and solvency of savings institutions, the authorities sought and obtained from the Congress the right to set interest rate ceilings that discriminate by the size of the deposit at all insured deposit institutions. As a result of this "gimmick" a pattern has emerged in which rates on retail time deposits are set at levels that protect the integrity of savings institutions, whereas wholesale time deposit rates are competitive with open market rates (Treasury bills and commercial paper rates). Whenever market rates rise, the authorities must choose between a run on commercial banks or raising the ceiling rate on wholesale certificates of deposit.

Each increase in the rate on wholesale certificates of deposit or market instruments raises the possible gain from arbitrage between the retail and wholesale time money markets. In unit banking states in midyear 1968, wholesale certificates of deposit were profitable investments for neighborhood banks with retail time deposits. New intermediaries and new instruments that skirt the regulations are obvious market reactions to such gaps. There is nothing sacred to the lower limit of \$100,000 for a wholesale transaction. This possibility of new intermediaries and new instruments is particularly interesting when the recent rapid growth in the value of commercial paper outstanding is taken into account since commercial paper seems to be an obvious vehicle for such arbitrage.

At the time of the crunch, commercial banks and the Federal Reserve had at best a vague idea of the total amount of outstanding lines of credit, partly because credit lines were often implicit and the most common way in which potential borrowers earned lines of credit was by keeping deposit balances. A "large" depositor assumed he was buying the availability of credit, and in the near-crisis of 1966 both bankers and depositors found this informal deposit balance convention embarrassing.

The crunch taught many firms that commercial banks were not always reliable sources of financing. Perhaps as a result, the past two years have witnessed an explosive growth of the value of commercial paper outstanding. Its growth rate over the period midyear 1966 to early 1968 was in excess of 40% per year, as the total amount outstanding rose from \$10 billion in January, 1966, to \$19 billion in the spring of 1968.

At present the commercial paper market is a wholesale market—the specialist dealers in commercial paper are among the most substantial of the Wall Street houses—and the typical instrument is so large that the difference between bid and asked is minute. Once again a large gap between open-market rates and rates available to retail time money is an invitation to arbitrage which could lead to a “run” on savings intermediaries. In addition to this danger, however, the growth of the commercial paper market has been associated with the development of a new relationship between banks and some of their large customers.

Over the past two years a rapid increase in contractual lines of credit paid for by an agreed-upon fee (say $\frac{1}{4}\%$ or $\frac{1}{2}\%$ of the line), rather than by a deposit, has taken place. For those firms that combine such contractual lines of credit with short-term financing by way of the commercial paper market, the commercial banking system is now the lender of last resort rather than the initial supplier of credit.

As a result the financial intermediary dealer in commercial paper is of increasing importance in financing business. The problems of how such dealers finance their position, whether a secondary market in commercial paper exists (or should be encouraged), and whether these dealers should have guaranteed refinancing rights are key problems relating to the evolution of the financial system that the Federal Reserve must face. The choice is how to guide market developments: whether to expedite the growth, to do nothing unless circumstances force some action, or to try to prevent any further growth.

The Federal Reserve could expedite the growth of the commercial paper market by making dealers in such paper eligible for accommodation at the discount window. It could create a barrier to these developments by requiring commercial banks to hold reserves against unused portions of contractual lines of credit, thus making it more expensive to use the banking system as a “residual” lender.

Decisions by the authorities whether to support, oppose, or do nothing with respect to the evolution of a financial market need to be based on a view as to how financial markets can best expedite economic efficiency, growth, and stability. It is apparent from the experience of 1966 that policies adopted when a particular stability crisis is at hand may succeed in achieving a short-term resolution

of the crisis while leaving market conditions that can breed further difficulties. Whereas segregating markets may have been an effective way of protecting savings intermediaries against an immediate run, savings intermediaries remain vulnerable to rising interest rates as long as the basic mortgage remains unchanged, and the availability of interest rate increases, or policies that lead to sharp increases in interest rates, is restricted.

Similarly, the combination of a much larger commercial paper market and contractual loan commitments can lead to a large increase in drawings from lines of credit whenever the Federal Reserve attempts a restrictive monetary policy. Banks, under these conditions, would either hold larger amounts of those short-term assets whose market is protected by the Federal Reserve or would tend to use the discount window more liberally than in recent years. In either case Federal Reserve restrictive policy would not effectively constrain the growth of bank reserves but would change the source and the price of reserves. If this is the way in which the money market is to evolve, then an evolution of all financial institutions and markets so that their stability is consistent with greater fluctuations in interest rates is in order. Once again the nature of the standard mortgage acts as a constraint. It seems that recent changes in money and financial markets are decreasing the availability of monetary policy as a technique for restraining undue expansion.

THE MANIPULATION OF UNCERTAINTY

The standard textbook model that shows how monetary and fiscal policy can be traded off to generate a desired level of income does not allow for anything as fragile as uncertainty, as the term will be used here. Ideas about uncertainty will be developed within the specific context of the usages and operations of financial institutions and markets.⁶

Financial institutions are organizations which take a position in financial assets by emitting their own financial liabilities. The contracts they own and have emitted state commitments to pay cash on demand, at a particular date, or in the case some state of nature or event occurs. Thus, for each portfolio there is a cash flow to and

⁶ The ideas about uncertainty that will be developed seem to be consistent with those of Keynes in his rebuttal to Viner et al.: J. M. Keynes, “The General Theory of Employment,” *Quarterly Journal of Economics*, Vol. 51, February, 1937.

a cash flow from, over every time horizon, that is explicitly stated in the contracts. The actual cash flows over every time horizon, however, depend on the way in which demand and contingent clauses in the contracts are exercised, and thus on the way in which outside economic and financial market conditions affect the organization. For each contract there is some probability (subjective) that the terms of the contract will not be honored. Thus there is a range of net cash flows with positive and negative values to this organization, with some probability assigned to each net cash flow.

In addition to the cash flows generated by the terms of contracts, cash flows can also be generated by buying and selling contracts in markets, including the sale of newly created contracts. Sales or purchases of assets to acquire or get rid of cash are called "position-making activities" if a short horizon determines the action, or "investment" if a longer horizon guides the activity. For each deficit or excess due to cash flows, some sales or purchases to make position will occur. When the market is functioning normally, the capital exposure from position-making activity is slight. The danger, which can result in significant losses, is that when a unit wants to make position by selling some particular asset, the relevant market is not functioning normally.

Thus, in addition to the frequency distribution of expected short falls and excesses of the cash flows to a unit, there is another type of uncertainty that exists in financial markets. This uncertainty relates to the state of the various money markets at the date a unit wants to make position by operating in those markets.

Note that an unfavorable state of a market does not mean simply that the selling unit has to make large price concessions. Each time a unit sells an asset some other unit takes the asset into position. The purchasing unit is accepting some capital exposure when this is done. If the potential purchasing unit's capital is already encumbered, as happens in a falling market, and if it believes the risk of losses is sufficiently great because of market disorganization, it will not take the position. In periods of rapidly rising interest rates, quoted prices of Treasury bills and other short-term securities always reflect transaction prices, but for longer-term securities quoted prices do not reflect any significant volume of transactions. In addition, the transactions that do take place in longer-term securities often carry conditions with them. The stated price can understate the true cost of making position by operating in these markets.

Rosa, in his fundamental paper on the availability doctrine, discussed the uncertainty introduced into the financial system when the "peg" was withdrawn from interest rates at the end of World War II.⁷ This discussion was concentrated on the market for government securities, and largely on the Treasury bill market. Even after the "peg" was withdrawn these markets were protected by the Federal Reserve's commitment to prevent disorderly conditions. Therefore, while reluctance could be induced by small losses, large losses, which could force a reexamination of desired portfolios by all units, were not available as an instrument of policy.

Once Federal funds, certificates of deposits and even municipal securities replaced government securities as position-making instruments, banks and other money market organizations became dependent upon the behavior of markets whose normal functioning was not guaranteed by the Federal Reserve. Under these circumstances it is possible that markets would not be working smoothly when needed. Thus the uncertainty of the 1960's and that to which Rosa referred are really quite different beasts.

As all units can be thought of as financial units, the cash flows to and the cash flows from income-producing units also can be analyzed by comparing contractual commitments to pay cash with cash flows from operations. The problem is always how much of an expected cash flow to a unit, given expected variability of the cash flow, will be hypothecated or pledged by issuing particular types of liabilities. A protracted period of rising prosperity, during which the economy is functioning ever more successfully, breeds a view in ordinary business corporations and financial institutions which allows them to raise their short-term payment commitments as a ratio, for example, to their expected cash flows from operations. A process of substituting one asset for another or of financing positions with liabilities that require a greater cash flow from the organization relative to the cash flows to the organization takes place. The simultaneous stretching of liquidity positions by corporations and by financial institutions is a characteristic of a boom economy.⁸

⁷ Robert Rosa, "Interest Rates and the Central Bank" in *Money, Trade and Economic Growth* (Essays in Honor of John H. Williams), New York, 1951, pp. 270-295.

⁸ The systematic transformation of portfolios over an extended boom as well as the formal cash flow model are examined in Minsky, H. P., "Financial Crisis, Financial Systems and the Performance of the Economy" in Commission on Money and Credit, *Private Capital Markets* (Englewood Cliffs, N. J., 1964).

If the Federal Reserve is confronted with such portfolio shifts as a major source of the expansion of credit by the financial system, it cannot, by its ordinary quantitative controls, force a quick reduction of credit expansion. Although in the long run, taking the good and the bad, it may be true that owned reserves are a good proximate determinant of the money supply and credit, it is also true that in the short run the relationship is not at all precise.

The weakness of quantitative controls during a period when velocity-increasing portfolio changes are major sources of investment financing is reinforced by the existence of a network of credit lines, explicit and implicit. This makes the loans of any particular date the result of prior and continuing business relations. In an expansion powered by an investment boom the Federal Reserve as well as the major money market banks seem to lose control over the volume of loans.

The liability structure that is acceptable to ordinary corporations and the asset and liability structure that is acceptable to financial institutions reflect both a view about the variability of the cash flows that result from income production, and the belief that, if the necessity arises, position making, by the sale of some assets or the emission of liabilities, will take place without any great sacrifice. Confidence in the normal functioning of financial markets and in the capacity of the system to maintain high-level income leads to an expansion which is not closely articulated to increases in the quantity of money. Increasing willingness to take risks underlies an expansion which is heavily financed by portfolio transformations.

In such circumstances, the Federal Reserve has one way to restrain the expansion. This is to make the desired liability and asset structures more conservative by reintroducing uncertainty. One way to do this is to have fluctuations in income and employment, i.e., by allowing depressions and recessions. Presumably this path is no longer open. Another way to engender uncertainty is to raise doubts that financial markets will function normally when the institution wants to use those markets. Thus disrupting financial markets may be a necessary tool of monetary policy.

The period leading up to the crunch saw the development of a wide spread between position-making rates such as the Federal funds rate and the discount rate. Obviously the barrier to borrowing at the Federal Reserve Banks was a tight administration of the discount window. The doctrine of not borrowing for profits was

transformed into a doctrine of not borrowing except with the acquiescence of the managers of the discount window. The traditional central banking doctrine of an infinitely elastic supply of reserves, by discounting eligible paper at a penal rate, was never fully applicable in the United States, because the eligible paper generally carried rates greater than the discount rate. The discount rate, nevertheless, was a penal rate to the extent that it was a more expensive way of making position than by using money market instruments. The rates of interest that are relevant to profitability of borrowing at the discount rate are not the rate on the paper pledged in the commercial loan tradition but the rates of interest on Treasury bills, in the Federal funds market, or in other position-making money markets.

In a tightly administered discount market, eligibility to discount becomes a matter of discretion. Such a discretionary discount window does not act as an automatic safety valve when money market tightness is abruptly induced by the Federal Reserve. Thus, when the Federal Reserve finally decreased the rate of increase in reserves during 1966, the rise of open-market rates above the ceiling rate on certificates of deposit resulted in a "run" on commercial banks, as certificates of deposits matured. Due to the growth of collateralized deposits and the decrease in government security holdings in general, banks were not able to make position by dealing in Treasury debt. During July and August they began to make position by decreasing their holdings of municipals, and the fall in municipal prices led to significant losses.

The combination of a tightly administered discount window, a sharp fall in the rate of growth of reserves, a rise in loan demand due to prior commitments to business organizations, and the attempt by commercial banks to make position by selling municipals resulted in disorganized conditions in position-making financial markets. While commercial banks were making price concessions in an effort to acquire liquidity, the Federal Reserve maintained its policy of tightly administering the window. With the breakdown in normal position-making activity, what has been described as near panic conditions appeared on the market. Everyone was certain that the Federal Reserve would do something to save the situation, but the question was when, and after what price had been paid. The Federal Reserve finally stepped in about September 1 and opened the window to banks that had been "good." In particular,

the window was opened to the pledging of municipal securities. This had the dual effect of stabilizing a market where prices had fallen precipitously and increasing liquidity by extending eligibility to a new class of paper.

CONCLUSION: THE DOMAIN OF THE FEDERAL RESERVE SYSTEM

The events of 1966 can be interpreted as the use of policy instruments to generate a near crisis, the objective being to break an investment boom by making "liquidity" valuable again. Because of the "fortuitous" escalation in Vietnam, no cumulative decline in investment and income took place. Because of the large size of the Federal government relative to the economy, a cumulative decline leading to a great depression is much less likely under any circumstances other than a financial crisis accompanied by a substantial reduction in the size of the Federal sector.

Given the large size of the Federal government and the unavailability of a substantial decline in income as a restraining factor in portfolios, the economy is poised, not on a knife edge but on a volcano. The danger is that an investment explosion financed by portfolio transformation will take place. To constrain such developments the Federal Reserve must operate so as to make liquidity valuable; this it can do by generating crunches, or allowing them to occur from time to time.

The existence of a ceiling rate on certificates of deposit means that the Federal Reserve can always induce a run on commercial banks. It can do this by not increasing certificate of deposit ceiling rates when rates on competing market instruments rise so that certificates of deposit are not attractive. In addition, the existence of other financial institutions and other markets means that the major impact of a rising interest rate pattern may not be at the commercial banks; in 1966 the savings intermediaries bore a great deal of the pressure.

As a result of the events of the 1960's, it is now clearer than ever that the domain of responsibility of the Federal Reserve System extends beyond the set of member banks. Even though the specialized deposit insurance and regulating agencies exist, the Federal Reserve remains the ultimate repository of liquidity and the other organizations require Federal Reserve cooperation if they are to carry out their responsibilities. Ultimately, the Federal Reserve is responsible for the normal functioning of the entire financial system.

This extended domain of responsibility is of greater significance if the generation of crunches is accepted as a method of applying Federal Reserve authority. In our complex interdependent financial system we cannot pinpoint where the rupture of usual financial practices will occur after the sharp application of financial restraint. The crunch technique first imposes losses and fears of great losses throughout the economy and then, by prompt Federal Reserve action, prevents any cumulative deflationary pressures from taking place. For the Federal Reserve to be able to operate in this way it needs to be able to pinpoint its lender-of-last-resort function, presumably by opening the discount window to the appropriate assets. Thus a reorganization of the structure of central banking so that the Federal Reserve is in contact with a wider array of markets and institutions may be in order, perhaps by opening and regularizing the discount window.⁹

The developments in commercial banking and corporate financial techniques which have resulted in closer cash management, growth of the commercial loan market, and greater rise of contractual lines of credit may mean that commercial banks will need ready accommodation at the discount window whenever restraint leads to a slowdown in the amount of commercial paper outstanding. Rationing through an open discount window, however, is rationing by price; thus monetary policy may require more rapid movements, as well as a greater range, for interest rates.

Given segmented markets, the ability of the financial system to function normally if interest rates rise rapidly is limited because of both the threat of arbitrage among markets and the weakness of savings institutions. As a result there are severe limitations upon the use of monetary policy to restrain a rapid expansion. The upward instability of investment, together with the accumulated weaknesses in our financial system, may mean that in the near future greater reliance needs to be placed upon flexible fiscal policy than has been true to date. This is so not because monetary policy is inherently weak but rather because of the peculiar set of institutional arrangements that now exists.

⁹ The Board of Governors of the Federal Reserve System, *Reappraisal of the Federal Reserve Discount Mechanism: Report of a System Committee* (July, 1968) seems to have adopted a somewhat similar position.