Monetary Policy and Credit Pressures*

By WILLIAM F. TREIBER
First Vice President, Federal Reserve Bank of New York

CURRENT ECONOMIC SETTING

The American people are enjoying an economic expansion of a length unprecedented except during World War II. This fine achievement has been accompanied in recent months by fast-moving developments in financial markets. The demand for credit has been pressing against the available supply. Interest rates have been rising, and capital markets are faced with heavy demands.

Our understanding and our judgment in economic and financial matters—as well as our willingness to act—are being subjected to a severe test. Will we cope with recent economic and financial developments in a way that will promote the continuation of our economic expansion at a sustainable rate and promote our other national economic goals? The stakes are high. Success is important.

ECONOMIC GOALS

By way of background, I would review with you, in the light of our national economic goals, the developments of the last five years, i.e., since the February 1961 trough of the last recession. Our goals include: (1) maximum sustainable economic growth, (2) maximum practicable employment, (3) reasonable price stability, and (4) equilibrium in international payments. These goals are interdependent. Inflation would soon distort growth patterns and undermine growth itself. Nor could we have, over the long run, maximum practicable employment at home, unless we have a strong dollar in international markets.

Most of the funds used by business for the expansion of plant and equipment, and by state and local governments for capital improvements, come from savings. A large part of the savings of the people is channeled through financial institutions, such as savings banks, insurance companies, and pension funds. The commercial banks are also depositaries of savings, but in addition they create credit. The commercial banks thus provide credit beyond the savings of the people. This additional credit equals only a fraction of the amount of savings, but it provides an important further stimulus to economic activity and a necessary base for growth. Through controlling the reserves of the banking system, the Federal Reserve is able to influence the amount of credit created by the banking system. Broadly speaking, the Federal Reserve seeks to foster the creation of enough credit to promote the attainment of our economic goals while avoiding the creation of too much credit which would tend to defeat their attainment.

RECORD OF LAST FIVE YEARS

ECONOMIC ACHIEVEMENTS. In the last five years gross national product rose by over 7 per cent per annum in money terms and by over 5½ per cent per annum in real terms. In 1965, the increase was over 8 per cent and 6 per cent, respectively.

In the last five years, there has been an even faster climb in expenditures by state and local governments on goods and services. Their spending on construction of all types rose by more than 10 per cent last year; the average rate of growth over the preceding four years was 8

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per cent per annum. This type of spending tends to be financed through debt securities. Last year capital issues of state and local governments rose to record levels.

In the same five-year period nearly seven million new jobs have been created. Seasonally adjusted unemployment has dropped from about 7 per cent in early 1961 to 3.7 per cent in February 1966. Unemployment among married men has been less than 2 per cent for the last three months, the lowest since 1954 when these statistics were first collected. Our basic unemployment problem today is among teen-agers and among unskilled workers, many of whom are Negroes or members of other minority groups. We are hearing more and more reports of a shortage of skilled workers.

During most of the last five years we have had greater stability in prices than at any time in the last two decades. But within the last year prices have been moving upward, and are clearly threatening our good record of price stability.

For nearly a decade we have had a persistent and severe deficit in our international balance of payments. The yearly average deficit from 1961 though 1964 was $2½ billion. In 1965, it was $1.3 billion; the reduction was due in large part to the voluntary restraint program which reduced the flow of capital funds abroad.

In summary, over the last five years we have failed in our efforts to achieve equilibrium in international payments, although good progress was made in 1965. We have done much better with respect to the other three goals. Our achievement over the period was promoted by a beneficial mix of fiscal policy and monetary policy.

FISCAL POLICY. Fiscal policy in 1961-65 was deliberately expansionary. The Federal Government was a net contributor to the flow of income, thus increasing the overall demand for goods and services. The major policy measures included liberalized depreciation allowances, an investment tax credit, and a large tax cut. The objective was to boost consumer and business purchasing power; the action proved highly effective.

MONETARY POLICY. Monetary policy also was distinctly expansionary during most of the current economic advance. Ample credit was available at home, but for balance-of-payments reasons short-term interest rates were prevented from declining to the extremely low levels they had reached in periods of expansionary policy in the 1950's.

The creation of substantial additional reserves for member banks allowed the banking system to expand deposits and credit. Readily available credit helped consumers to finance additional purchases, helped business to invest in more plant and equipment, and helped state and local governments to raise vast sums above current tax revenues.

As the economy moved closer to full utilization of resources last year, signs of inflation appeared. There was a distinct speedup in the rate of advance of consumer and wholesale prices. Monetary policy responded by gradually shifting from ease toward mild restraint. Reserve availability was reduced and the banking system was obliged to move into a net borrowed reserve position, i.e., all member banks as a group were borrowing more from the Federal Reserve Banks than the total excess reserves held by all member banks. The Federal Reserve thus refrained from creating sufficient reserves to permit banks to accommodate all the increased demands for credit at unchanged interest rates. In December the Federal Reserve expressed its concern about the changing economic environment by raising the discount rate from 4 per cent to 4½ per cent. Rising interest rates were not sought as an end in themselves. They reflected the booming demands for credit and a need to prevent an excessive and inflationary upsurge.

Indeed in 1965 the Federal Reserve provided a large amount of reserves—enough to support a substantial growth in bank credit and in the money supply. In 1965 more funds were raised by borrowing than in any other year. To put it another way, the Federal Reserve did not seek—and it does not seek—to bring the bank credit expansion to a halt; it seeks only to moderate the pace of the expansion so that the overall economic advance can be sustained. Even though there were net borrowed reserves, the Federal Reserve continued to create a substantial amount of additional reserves and to facilitate further growth in bank credit and in the money supply.

If the Federal Reserve had not exercised moderate restraint, even more bank credit would have been created and the resultant increased bidding for productive resources would have led to still greater total claims on these resources. Price pressures would have been much stronger than they were.

INFLATION

For several years inflation was not a problem in the United States. But today prices are rising, and the risk of inflationary distortion is obviously greater than at any time in the last half decade. The difficulties of measuring the precise extent of inflation do not long obscure an inflationary trend once it is under way. Once under way, inflation is difficult to stop; and stopping it creates other problems.

Inflation seriously distorts the distribution of income. It affects most severely those persons least able to help themselves. It has quite properly been called "the cruelest tax". Inflation is, in effect, a universal tax on savings and thus undermines the basic motivations for individuals to save. Inflation distorts business decisions and encourages speculative excesses; it creates uncertainty in business investment decisions, particularly those which extend over a long period. Inflation is a major threat to equilibrium in our international accounts; by raising the cost of goods we sell to foreigners, and by encouraging imports inflation would seriously and adversely affect our international trade surplus; thus it would quickly ruin the progress we have made in reducing our balance-of-payments deficit. Inflation has a detrimental effect on the long-run willingness of investors to acquire fixed yield securities, such as mortgages, corporate bonds, and of course the obligations of state and local governments. Inflation sows, and nurtures, the seed of an eventual economic downturn.

OUTLOOK FOR 1966

Although 1966 is young, it is apparent that claims this year on the nation's real resources are potentially excessive. Virtually all forecasts of gross national product indicate another rise equal to or larger than that of 1965. Despite all hopes for settlement of the Vietnam conflict, there is no reasonable expectation of an immediate substantial reduction in expenditures connected with Vietnam. Indeed, the conflict continues to require increased Federal spending.

Businessmen are highly optimistic; they are planning to spend this year a sixth more on plant and equipment than they did last year, and last year they spent a sixth more than they did in 1964. In past periods of expansion, actual capital expenditures by business have exceeded preliminary estimates. When the additional plant and equipment are in operation, they will no doubt contribute to enlarged output and the more efficient production of goods. But before this happens the expenditures to create them exert further pressures on the available supply of goods and services.

There are no strictly comparable data on the capital spending plans of state and local governments, but it is widely expected that such spending will increase. In addition, consumer buying intentions are strong.

From these reports and other data, it is apparent that our economy, and particularly the nation's credit markets, will be subject to continuing strain as the year progresses.

Naturally our military effort and general defense effort will continue to have first claim on our national resources. While we foresee another good gain in the labor force and plant capacity during the coming year, shortages of skilled labor and supply bottlenecks easily could become more common. The possibility of further increased price pressures is evident.

APPROPRIATE ACTION

Everybody wants further genuine economic progress. But when growth is accompanied by a substantial increase in prices, the progress is not genuine. Modest restraint early in a period of inflationary pressures will pay large dividends later.

The traditional method of dampening such pressures has been through general, indirect controls affecting overall demand. By preventing demand from increasing too rapidly, opportunity is afforded the market mechanism to assist in equating the demand for goods and services with the supply. The two principal general controls are fiscal policy and monetary policy.

The use of these general controls avoids having any governmental body decide who should get credit and how much, and who should not get credit at all. Judgments in this respect are exercised in the marketplace. And, of course, we want to avoid the direct control of wages and prices and other aspects of our economic life.

FISCAL POLICY. Fiscal policy involves what and how the Federal Government takes from the people in the form of taxes and otherwise, what it spends, and how it spends. The President has just signed into law legislation to rescind certain reductions in excise taxes that became effective January 1, 1966, to increase the withholding on individual income taxes, and to speed up the payment of corporate income taxes.[1] This fiscal policy action will help to restrain overall demand. Yet many informed observers question whether it will do enough. In their view, a further increase in taxes, some reduction in contemplated spending, or both, are needed.

Despite the speed with which the most recent tax bill was enacted, further fiscal action is likely to bring more discussion and debate in Congress, and the enactment of effective legislation could take much longer. A proposal for a tax increase is likely to produce debate not only on the nature of the increase and on whom it falls, but also on the question of what expenditures could properly be reduced. The Joint Economic Committee of Congress has expressed its concern about inflation and has urged fiscal action to combat it. The majority stresses increased taxes; the minority stresses reduced spending. In my view, it is not too soon right now for Congress through its appropri-

[1] Tax Adjustment Act of 1966, approved March 15, 1966.

ate legislative committees to consider what further fiscal policy steps would be appropriate.

MONETARY POLICY. Monetary policy has been used to moderate the growth of bank reserves, and thus dampen the rate of increase in the expansion of bank credit. In the current setting monetary policy will continue to be used to that end. Credit cannot be expected to grow at the extraordinarily rapid rate at which it grew last year. This does not mean that monetary policy will be used to bring economic growth to a jarring halt. Reserves should continue to be supplied to help banks provide credit needed for sustainable economic growth.

BANK CREDIT. In the last few weeks a number of commercial banks, recognizing that they will not be able to satisfy all credit-worthy borrowers, have taken steps to restrict lending to essential loans. In varying degrees banks have encouraged customers to reduce the amounts of requested loans, to postpone borrowing, and to go to the capital markets rather than the banks for credit; and in some cases loans to credit-worthy borrowers have been refused. The recent increase in the bank prime rate should complement these other steps being taken by the banks. The higher prime rate should discourage some credit demands, and should encourage business concerns in need of long-term funds to seek those funds in the long-term bond and equity markets. It should help to check a growth in total spending on goods and services that threatens to become excessive.

In times of tightness, banks view lending to their customers as more important than acquiring securities for investment. Under present circumstances, many banks may confine their purchases of municipal securities to those of municipalities with which they have direct customer relationships. It is clear that in the foreseeable future banks will not play the important role as buyers of municipal securities that they have in recent years.

MUNICIPAL BORROWING. From what I have said so far, it is apparent that, in my view, state and local governments in general should not at this time seek to continue the rapid expansion of the borrowing that they have undertaken in the last five years. As financial advisers to such governments and as underwriters of their securities, you will play a vital role in their financial plans in the coming year.

In the current situation of high credit demand, all state and local governments should ask themselves a variety of questions, such as: Is it necessary that spending for a particular purpose be undertaken at this time, or can it be postponed? If spending for a particular purpose must be undertaken now, would it not be advisable to seek to obtain all or part of the necessary funds through taxation rather than borrowing?

In 1951, at the time of the Korean conflict, certain criteria were established under a voluntary credit restraint program designed to curtail the total amount of credit while not interfering with essential credit.[2] I do not suggest the adoption of a similar program at this time, but I do suggest that it would be desirable for municipalities and municipal securities dealers to ask questions in a similar vein about issues now proposed. In 1951 it was suggested that careful scrutiny be given to issues of municipal securities involving: (1) the replacement of facilities that could continue to perform their function, (2) the construction of less essential facilities, such as war memorials and playgrounds, (3) the acquisition of rights of way not immediately needed, (4) the purchase of privately owned utilities by municipalities which involved borrowing to replace equity capital, and (5) excessive borrowing in anticipation of taxes or other revenue.

The situation today is not strictly comparable to that of a decade and a half ago. Our military forces are much stronger today, and we do not need the massive buildup required at that time; there is more leeway in the economy now; a greater capacity for growth is in prospect; monetary policy is now being used to restrain excessive aggregate demand; and current priorities probably are not quite the same. Nevertheless, some self-restraint in lending and in borrowing is needed, and some tests must be applied to encourage borrowers to cut down their borrowing.

Today, there are at least two additional types of issues that should be scrutinized carefully. One type is a security issued by a municipality in advance of the need for funds in order to invest the proceeds of the security at a profit. The Comptroller of New York State recently stated that a municipality may not issue tax or bond anticipation notes where the dominant purpose is to borrow funds to invest at a profit.[3] The New York Comptroller's advice is good for any governmental body anywhere and for any kind of tax-exempt security. The second type is an industrial development bond—a security issued by a governmental body to finance the purchase or construction of a plant to be leased to a business enterprise. Regardless of the effect of these two types of securities on resource utilization, their issuance at this time would add to current pressures in the capital market. There is of course a more fundamental objection: the issuance of such securities at

[2] See Bulletin No. 3 of Voluntary Credit Restraint Committee, 37 *Federal Reserve Bulletin* 498 (May 1951).

[3] Statement of Arthur Levitt, Comptroller of the State of New York, dated February 14, 1966, entitled "Statement of Policy Relative to Municipal Borrowing for Investment Purposes".

any time appears to me to be contrary to the public interest.

Quite possibly we have seen already the first signs of a most desirable self-restraint on the part of local governments. Since the end of January several dozen municipal offerings have been postponed or withdrawn, or have not been awarded because of unacceptable bids. Despite this restraint, it appears that more municipal securities have been sold so far this year than in the corresponding period last year.

Would not local governments be well advised now to finance expenditures out of current taxation to the maximum extent possible? If spending must exceed current revenues and their likely short-run growth, financing a deficit through borrowing will throw an additional burden on the capital markets now and will mortgage future revenues with high interest charges. The only important, but quite dubious, virtue of such procedure may be to postpone unpleasant but inevitable additional taxes.

Some postponement of credit demands in general and an orderly scheduling of those demands would reduce current pressures in the capital market, and would reduce the pressure on resource utilization. Any municipality that issues bonds today commits itself to pay high interest for a long period. An easing of the Vietnam conflict, or a decision to raise Federal taxes, could bring a change in market conditions.

CONCLUSION

The basic strength of the American economy, and the conviction that it can provide an abundant life for all, should not obscure the fact that we now face a problem of economic priorities. The real resources of the economy now and in the immediate future cannot satisfy all the immediate desires of everyone.

Each municipality must judge for itself the immediacy and the intensity of the need for borrowing. Each investor must judge for himself whether, in the light of the overall situation, he should invest in a particular security of a particular municipality. Each municipal securities dealer must judge whether the sale of a proposed issue of municipal securities would in the long run be a service to the municipality and promote the economic goals of the nation. As these judgments of many persons are made from day to day, I would trust that their overall effect would reduce the pressures on the money and capital markets and promote our national economic goals.