Interest Rates and Monetary Policy in Perspective*

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It is very pleasant for all of us in the Federal Reserve Bank of New York to meet again with our good friends of the New York State Bankers Association. As I look back at some of our reunions of past years, the circumstances surrounding some of those earlier occasions seem comparatively uneventful. Certainly banking and central banking matters have been more in the limelight in the past two or three months than for a great many years. Our monetary actions and the reasons therefor represent ground that has been pretty well worked over. However, I would like to review with you some of the basic economic philosophy behind these recent dramatic events, and if I touch briefly on the events themselves it is merely to bring these underlying concepts into clearer focus.

I have been saddened to find so many glaring misconceptions of the role of monetary policy in much of the comment made in the past couple of months. And there seems to have been equal confusion on the part played by interest rates in general in the environment of a market economy. Much of what I have to say today may strike this financially sophisticated audience as obvious and elementary. Nevertheless, I think it may be worthwhile to go over with you a few of the fundamentals.

In the first place, let's look for a moment at the connection between monetary policy and our basic economic objectives such as maximum sustainable growth, a reasonably stable price level, maximum practicable employment, and near-equilibrium in our international payments. The linkage, of course, runs from specific monetary policy actions (open market operations, changes at the "discount window" and in reserve requirements) to the cost and availability of credit (and especially bank credit), thence to changes in the amount of private and public spending, and from there to changes in real economic activity, use of resources, price relationships, and international payment flows.

Of course, the nature of this "linkage" is immensely complex and is the subject of continuing searching analysis by economists in the Federal Reserve System and in Government generally, and in our universities and research organizations. The chain of cause and effect is still far from being susceptible to exact scientific measurement, so that judgment remains an essential element in analyzing not only the probable direction and strength of various influences but also the probable time lags involved. The fact that monetary policy moves cannot be fitted into an exact scientific formula does not mean that they are not well worth making. On the contrary, the world has learned, through a long process of trial and error, that monetary policy is one of the best methods—and undoubtedly the most flexible method—for exerting a generalized impersonal influence on borrowing and spending and thereby on economic activity while still permitting market forces to control most individual economic decisions. Granted that monetary policy may, and often does, affect different parts of the economy somewhat differently, this is a far cry from a selective method of control where the national Government would undertake to judge the social value of each and every economic activity and to set policies accordingly.

Fiscal policy is of course another important way of exerting a generalized influence on the economy, although both taxes and Federal expenditures inevitably involve very significant differential effects on various parts of the economy. One of the great gains of the last couple of decades has been the growing recognition that fiscal policy is a very useful and potent tool for speeding a recovery,

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sustaining an expansion, or checking a boom.

Because changes in taxes and Government outlays directly affect the spending stream, fiscal policy is undoubtedly an even more powerful economic weapon than monetary policy. It suffers, however, from one exceedingly serious drawback—lack of flexibility. This reflects the long process of legislative and administrative actions that must take place before a given policy recommendation is adopted and produces its economic effects. If Congress were able to speed its own deliberations and decisions, or if it were willing to delegate to the Executive Branch some modest leeway in determining tax rates, or more than the existing limited discretion with respect to expenditures, the drawback might be overcome in some degree —and I would hope that continuing study will be devoted to these possibilities. But, as things stand now, fiscal policy is clearly a poor second to monetary policy with respect to the potential for quick adjustment to changing conditions. The Federal Reserve System has the technical capability of adjusting its policies on a week-to-week or even a day-to-day basis.

The discount rate increase in early December brought forth several critical comments to the effect that, if inflation was threatening, fiscal rather than monetary policy should have been looked to for remedial action. It was argued that monetary restraint might react primarily on investment activity and hence on future productivity growth, whereas fiscal restraint would be more likely to dampen consumption. Interpreting these comments broadly, I agree that monetary policy should not always be relied upon exclusively to bring about whatever restraint is needed. However, in the specific December 1965 situation, the critical comments conveniently overlooked two important elements: first, the fact that there was little prospect of a significantly tighter fiscal policy that would become effective in the next few months rather than a year or so from now; second, the existence of our international payments problem, which has certainly not yet been solved despite the past year's notable progress. Both of these points merit some elaboration.

While timing is of course always a significant factor in any "policy mix", there is no rule as to whether fiscal or monetary policy must move first. Each must move in the light of past, present, or contemplated moves of the other type of policy. Late last fall it was clear that the Federal budget was tending to become more of an expansionary force during the remainder of fiscal 1966 than had earlier been expected, so that some firming of credit conditions was consistent with the avoidance of more total stimulus from both types of policy than had been deemed right just a few months earlier. In these circumstances, pleas that monetary moves be delayed until after the presentation in January 1966 of the budget for the 1967 fiscal year did not seem to me persuasive. The need of the moment was for action that would immediately work to counteract incipient and actual inflationary developments before they gathered further momentum. It is gratifying to note that the President's fiscal 1967 budget, as forecast in the State of the Union Message, gives clear recognition to the threat of inflation and offers fiscal proposals that will help to deal with it.

When there is a choice between checking an inflationary threat through stiffer credit terms and checking it through higher tax rates or restraint on Government outlays, there is little doubt that the former will be more useful from a balance of payments point of view. (This aspect deserved special emphasis in early December when the Government was about to announce a tightening of the President's balance of payments program.) There is, of course, plenty of room for argument as to just how much balance of payments influence a monetary policy action may have, but it would be very hard indeed to contend that it will not bring some benefits. Indeed, for the past four or five years we in the Federal Reserve Bank of New York have suggested in our annual reports that the determination of a desirable policy mix between monetary and fiscal policy must take full account of international factors. Thus, from the earliest days of the talk of tax reduction we supported a tax cut primarily because it would tend to put unused domestic resources to work without running the international risks inherent in too easy a monetary policy. The tax cut, both in anticipation and in realization, enabled the System to maintain a lesser degree of monetary ease than would otherwise have been called for by domestic considerations. The argument that international factors must be given full weight in determining the proper fiscal-monetary policy mix has as much validity today—with our payments problem still unsolved—as it had five years ago. Yet it receives, in my judgment, far too little recognition in most press and academic pronouncements. Naturally, this is not to deny that at times both monetary and fiscal policy should simultaneously move toward restraint or ease. In fact, right now is a time when both types of policy should jointly combat a resurgence of inflationary forces.

Now let's turn for a minute to the role played by interest rates in general in our economy. The level of interest rates has long been regarded as the balancing mechanism between credit demands on the one hand and credit supplies on the other. Besides providing a kind of thermometer to measure these respective pressures, interest rates also exercise an influence of their own on both demand

and supply. Demand is spread in roughly even proportions among consumers, private business, and Government entities (with the Federal Government representing only a modest share of total borrowing except in time of war). On the supply side, savings of course represent by far the largest source of credit, and it is well to bear in mind that to a very considerable extent the commercial banks operate in the same way as any other financial intermediary when they issue relatively liquid claims in return for savings which are then directed into long-term investment channels. At the same time, the commercial banks also of course retain the unique characteristic of their power to create money, in the form of demand deposits, as the counterpart to their extension of credit. This unique power plays a marginal but strategic role in balancing total credit demand and supply.

One important factor entering into our recent discount rate decision was the very rapid growth of bank credit in 1965—at about 10 per cent per annum, as against an already rapid rate of around 8 per cent in each of the four preceding years. We had in mind not only bank credit but also total credit creation, which had grown at a fast pace, too, although the banks had accounted recently for a somewhat larger share of the total than earlier. It was a source of concern to us that the fast and perhaps accelerating pace of credit expansion was occurring in an environment of growing scarcity of resources in the form of unemployed labor and unused plant capacity. With unemployment down sharply in the past year, there was a real question whether continued rapid credit creation would not do more to encourage borrowers to bid up prices rather than to help in bringing about further rapid gains in real economic activity.

Some critics have cited the rather modest growth (around 4 per cent per annum) of the money supply—demand deposits plus currency—in recent years as evidence of an excessively restrictive monetary policy. They might well reflect that the public, and especially business, has been eager to economize on cash balances in order to earn interest on other forms of liquid assets. The aggregate of these other assets has risen much faster than the money supply proper; and, in contrast with earlier periods of business expansion, total liquid assets of the nonbank public have grown more rapidly than the gross national product since early 1961. Whatever ailments our economy may have been subject to, it has certainly not been short of liquidity.

I have spoken of the December discount rate action as being motivated partly by a wish to check too rapid a growth of bank credit. It has been rightly pointed out on many occasions, however, that the rate action's effectiveness will be largely determined by the extent to which it is supported by restrictive open market operations. Discount rate changes and open market operations are complementary instruments of policy, with the latter playing the dominant role on a day-to-day, week-to-week basis because of their influence on bank reserve positions and, at one step removed, on bank credit growth.

I might add, however, that neither the System's intent with respect to the rate of bank credit growth nor the likely actual result should be judged on the basis of the published free reserve figures alone. A given free reserve position or net borrowed reserve position may produce differing rates of credit growth, for the banking system's response can vary widely according to the force of credit demands. If credit demands were very strong, the maintenance of a net borrowed reserve position of "X" million dollars, for example, might result in very rapid credit expansion, whereas in a period of stagnant demand it could lead to little or no credit growth.

A discount rate change is always in some degree merely a mark of official recognition that market interest rates have been on the move. As Chairman Martin said in an address last month, it would be harmful to increase the discount rate if the natural forces of the market—which reflect the underlying strength or weakness of the economy—were moving in the opposite direction. Actually, market rates had been rising very strongly for several months before the December discount rate increase. There is always room for judgment as to how soon the discount rate should be moved to conform to, or even perhaps to anticipate, such a market trend. Last December a number of rather glaring distortions had occurred in the interest rate structure, and it was rightly felt that a discount rate rise would tend to ameliorate these rate distortions, thus promoting a more orderly flow of funds in the economy.

Whether or not a discount rate change must be mildly or strongly reinforced through open market operations will depend on factors that cannot be accurately measured at the time of the rate move. To some extent the rate move itself, and related changes in market rates, can be counted on to affect the strength of credit demands and the supply of savings. Our disposition in December, given all the special seasonal pressures that are characteristic of that month, was to ease the transition to a new rate level by making reserves somewhat more abundant than they had been a month or two earlier while still avoiding any flooding of the banks with reserves that might have seriously misled the market as to our underlying policy. We are watching developments closely. Our open market operations will be guided by cumulative evidence of the effect of the discount rate move on the pace of money and credit expansion and related economic and financial developments, and by the extent to which bankers themselves exercise good judgment and are selective in meeting credit requests.

By this time it should be reasonably clear, if my exposition has not been grievously obscure, that interest rates are not just another price, like that of any commodity, a rise in which may be a signal of inflation to be combated by right-thinking public servants. Yet it was startling how often I heard just such comments at the time of our discount rate increase. Several friends in the business community asked me how the System could, in good conscience, make this contribution to an upward trend of prices in general; and remarks in the same vein even came surprisingly enough from the mouths of a few trained economists. Now it would be wrong to assert that interest rates do not play a significant role as an element of cost. In some economic sectors this aspect is especially important, as in housing or in investment projects undertaken by state and local governments. In political circles it is popular to stress also the large Federal bill for interest charges, with a consequent higher level of tax rates or budget deficit than would otherwise be necessary. All this is no doubt true. Yet it is frequently overlooked that the inflation-checking influence of higher interest rates is vastly more important than this cost aspect for the economy as a whole. Since interest represents the cost of borrowing money to be injected into the spending stream, higher interest rates will tend to slow this process and thereby to minimize the upward pressure on prices and costs that reflect excessive spending. In a very important way, then, interest is not only not just another price but is the exact opposite of a commodity price. In his testimony before the Joint Economic Committee last month, Governor Balderston showed how much more serious for a municipal government a general commodity price rise could be than an increase in the same government's interest cost on borrowed funds.

Another fallacy worth mentioning is the tendency to attribute higher interest rates simply to the insatiable greed of the bankers. This strand of thought is a holdover from the ancient Populist theories which have long since lost whatever validity they might once have had in a rather primitive and largely agricultural economy. In our present highly developed economy, all income groups participate importantly in saving and benefit directly or indirectly from the flow of interest payments. Under these conditions, it is pretty hard to tell whether the greater social benefit will follow from lower or higher interest rates *per se*. What is not at all hard to tell, however, is that a great number of people are badly hurt by general price increases.

As for the argument that higher rates benefit only the bankers, I hardly need to remind this audience that interest is one of the banker's largest items of cost besides being a major item of income. Perhaps it is worth pointing out that some of the loudest protests against the recent lifting of ceilings for rates on certificates of deposit came from bankers who feared their inability to cover this important increase in cost that was resulting from deposit rate increases at competing institutions. In any case, as I have said before, the really important question is not whether the interest rate level is high or low but whether it is "right" for the economic circumstances.

Let me add a word here on the significance of the changes made last month in Regulation Q. At that time it had been increasingly clear for many weeks that the existing ceilings were inconsistent with rising market interest rates resulting from strong and growing credit demands. Actual rates for certificates of deposit were right up against the ceilings. Unless the ceilings had been raised, any further rise in market rates could have caused a major loss of deposits to many banks, and the resulting effort to liquidate assets could have had serious consequences for the municipal bond and mortgage markets. Furthermore, the law behind Regulation Q was enacted—rightly or wrongly—not as a means of regulating interest rates by fiat for their own sake but as a supplementary means of protecting the banking structure against unsound lending and investing policies that could result from pressure to cover excessive outlays for the payment of competitive deposit rates.

In this setting it was surprising that some of the System's critics last month suggested that it would have been better for the monetary authorities to combat any inflationary threat through further moderate pressures on bank reserve positions rather than by overt moves involving the discount rate and Regulation Q ceilings. Further pressure through open market operations would merely have accentuated the fact that both the discount rate and the Regulation Q ceilings were increasingly out of line with market realities with the consequences I have already enumerated. Moreover, the alternative of a "revalidation" of existing certificate of deposit rates through easing the pressure on bank reserve positions would have been equally inappropriate because it would have encouraged a further speedup in credit growth. Thus, the need for relief on the ceilings was a significant reason behind the timing of the policy moves. And it would have been most unwise to raise the ceilings without touching the discount rate, for in that case there would have been even greater uncertainty in the money and capital markets, in the belief that a discount rate rise would have to come at some time in the fairly near future. This was an occasion when the discount rate and Regulation Q moves had to occur simultaneously.

Their simultaneity, however, has had one unfortunate result, i.e., that commentators have tended to disregard the basically different nature of a discount rate increase and a lifting of Regulation Q ceilings. The latter action involves setting a permissible maximum, with the determination of the actual rate left entirely to a free market. There was a lamentable tendency to speak of the System's having increased "the rate paid on time deposits" to 5½ per cent. A major reason for setting the new ceiling at this historically high level was in fact to make crystal clear that the System was *not* trying to designate a desirable rate—which had tended to be the interpretation of earlier more modest increases in the rate ceilings.

The establishment of the 5½ per cent ceiling implies a philosophy which I have long shared, i.e., that to the greatest extent possible we should leave the establishment of both deposit and loan rates to the best judgment of the banks themselves—and the competitive markets within which they operate—with interference by the System only if abuse of this freedom is evident. In the first instance this interference might consist mainly of suggestions from the bank examiners. The freedom of action of which I speak should, of course, apply to the prime rate as well as any other lending or deposit rate. It does obviously imply the need for a high degree of responsibility and prudence on the part of the bankers themselves. For a good many years, Regulation Q ceilings provided a sort of "umbrella"—or perhaps a "crutch" would be a better term—that relieved the banks of some of this responsibility; and there have been, surprisingly enough, outcries against the lifting of the ceilings by individuals who in nearly every other field are staunch supporters of free enterprise. In any case, I trust that the bankers will live up to their greater responsibilities and will exercise prudence in preventing runaway competition from causing sharper rate increases than are consistent with the real forces of supply and demand. The System must remain vigilant in this area, but I am optimistic that our faith in the maturity and prudence of the nation's bankers will be justified.

I have tried to cover a good deal of ground today by touching a few highlights rather than by exploring our actions in considerable depth. As I said at the outset, our December policy moves seemed to provide a useful background against which to review some of the fundamentals of interest rates and monetary policy. Ours is an art rather than a science, but one which is gradually becoming more susceptible to scientific analysis. We make no claim to omniscience, and our judgments may prove faulty from time to time. But the great beauty of monetary policy is the fact that it need never stand still but can be and is indeed being adjusted constantly to developing events. I hope you agree that a vigorous Federal Reserve System, maintaining the closest contacts with other arms of Government but exercising independent judgment within the Government, can play a useful role in fostering the balanced economic progress we all seek.