Monetary Policy in an Overheated Economy*

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I am very glad indeed to have this opportunity to address a distinguished gathering of this kind in Dallas. For one thing, it is the first occasion I have had to come here since my association with the Federal Reserve, although I have had the pleasure of working closely with my highly respected colleague, Bob Irons, for more than ten years. Incidentally, as you probably know, Bob is the dean among Reserve Bank presidents. I suppose that a New Yorker is sized up pretty carefully out here in this great and growing part of the country. But actually I am sure that these East-West differences are very much overdone —that all of us are seeking pretty much the same goals. I assume we all wish to give private enterprise and the market economy maximum scope, while at the same time seeing that the public interest is adequately protected through the activities of Government—all for the purpose of achieving maximum sustainable economic growth, with high employment of resources and substantial price stability, together with near-equilibrium in our international payments.

Today I would like to share with you some of my thoughts on what monetary policy has been trying to do in 1966 to further these goals and to what extent it has run into difficulties. I would be the first to admit that the record of monetary policy this year has been largely one of careful improvisation rather than of following some clearly mapped path. To some extent, of course, monetary policy is always a matter of adapting policy flexibly to changing circumstances; but this year the changes in circumstances were more abrupt and the uncertainties more pronounced than usual. Some of the steps we have taken I would not regard as particularly useful measures over a longer period, although they did meet a pressing temporary need. To my mind, the overall record of Federal Reserve policy this year is one of substantial and meaningful achievement, although naturally the record is not perfect.

Of course, the major factor dictating the general shape of our policy has been the clear emergence of inflationary pressures, as a rapidly expanding defense effort has been superimposed on a growing civilian economy that was already—by late 1965—employing virtually all usable resources of labor and plant capacity.

If I lay greater emphasis today on the goal of price stability than that of economic growth, it is not, I assure you, because I consider price stability more important. Rather it rests on my view that—notwithstanding the improved performance of some price indicators in recent months—now seems to be a time when the danger of inflation is clear and present, whereas the danger of recession is problematical and relatively remote. Even after due allowance for some recent cooling in the hectic pace of several sectors of the economy, I believe that overall production and consumption are still heading upward from their current all-time high levels, sparked mainly by the rapid expansion of defense spending and of business outlays on plant and equipment and supported by rising consumer income and expenditures. The strength of aggregate demand has for some time permitted—indeed encouraged—producers of goods and services to raise their prices on a broad front; and, with employment of resources close to a practical maximum, shortages of skilled labor are now tending to exert strong pressure on wage rates. Furthermore, the increase in the consumer price index, which proceeded at less than 1½ per cent per annum in the years 1961-64, has accelerated to a rate of 3 to 4 per cent. Recent price increases fortunately have been much less rapid than they were during the Korean war.

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Nevertheless, these price increases have brought renewed and widespread interest in cost-of-living escalator clauses —which are almost an invitation to futher inflation—and have given rise to demands for wage increases far in excess of prospective overall national gains in productivity, thus threatening the so-called guideposts with extinction. If these demands are granted—and there seems to be not enough determination to resist them—there will be inevitable upward pressure on prices, although profits may have to bear some of the initial brunt of this cost push.

An additional reason for my emphasis on price stability is that, whereas economic growth seems to have countless strong advocates, both in and out of Government, the fight against inflation has a much less numerous and devoted following. In fact, I am disturbed by the degree of complacence on inflation one finds in this country. All too many citizens, including some leading businessmen, seem to assume that "a little inflation" is a reasonable price to pay for continuing economic growth. When "a little" meant a rather steady upward drift of about 1½ per cent per annum, there was something to be said for this view. But at 3 to 4 per cent per annum a different view must be taken. There is no time tonight to go into all the reasons why inflation *is* an insidious danger, involving all sorts of threats of inequity besides carrying within itself the seeds of business excesses and subsequent business recession. But if the domestic consequences of inflation are not sufficiently disturbing, I need only mention the additional grave danger that inflation poses for the international standing of the dollar. It is not too much to say that our basic hope for international payments equilibrium rests on a reversal of the recent deterioration in our trade balance—and in the long run such a reversal in turn depends very largely on the avoidance of inflation of American costs and prices. The current bulge in imports may be cured by a slowdown in the rate of business expansion; but our competitive position, which has been benefiting from our relatively good performance in the past few years, would be permanently damaged by a higher cost-price structure. That leads me to stress the most pernicious aspect of inflation, i.e., the fact that it is virtually irreversible, in the light of the political and social realities of our economy. Those who are unwilling to run some risk of a mild and temporary slowdown in the expansion of the domestic economy in order to win the battle against inflation are overlooking this basic difference in the degree of *permanence* of the damage involved.

Monetary policy has long been recognized as one of the most useful general tools available to the national Government to make possible the achievement of our country's economic goals. It exercises a broad and pervasive influence, with minimum interference with individual economic decisions; it avoids a system of direct Government control of individual transactions, a system most of us would not want to see. However, as has been said so often by Federal Reserve officials, it would be a serious mistake to assume that appropriate monetary policy alone is sufficient to assure a well-balanced economy. If monetary policy is relied on too heavily and is pressed too far, there is always a real danger that it may lead to a financial crisis or a serious reversal of the economy, or both. So in recent years there has been much talk of the policy "mix", with a very logical development of economic thinking, and more recently of political thinking, along the lines of giving fiscal policy an important role in the search for sound economic growth and stability.

When we speak of deliberate use of fiscal policy we have in mind control over Government expenditures and over tax rates. In contrast with our readiness to accept scientific and industrial innovation, the United States has been rather late, among nations, to accept the deliberate use of fiscal policy to influence the state of the economy. But most foreign industrialized countries, though well ahead of us in accepting this theory, have not been especially successful in putting it into practice. I believe our actual record in using fiscal policy as a stabilization device is as good as that of most other countries.

The outstanding example of successful use of fiscal policy in this country was undoubtedly the combination of stimulative measures taken in 1962-64, including the 7 per cent investment credit and liberalized depreciation rules and culminating in the general reduction in personal and corporate income tax rates early in 1964. There is no doubt in my mind that the country's remarkable economic record of those years owes much to these measures. Yet many of those who favored the tax cuts did so less because of belief in fiscal policy than because they simply thought taxes are always too high and should always be cut if possible. Still others resisted the tax cut because it did violence to a strong belief in a balanced budget *per se*. My own opinion is that, from the point of view of economic stabilization, the appropriateness of a particular level of Government expenditures and a particular level of tax rates must be judged primarily in the light of their implications with respect to aggregate demand as compared with available real resources. When, around mid- or late 1965, our economy passed from a stage of sound expansion to a stage of overheating, there should have been a general willingness to consider timely use of fiscal policy in the reverse direction, i.e., as a means of deliberately slowing the pace of the economic expansion.

In view of the difficulty of effecting a major cut in Federal expenditures in a timely manner—more particularly in the light of the rising Vietnam outlays—meaningful fiscal policy meant a general tax rise. A good many leading economists—and, I might add, many Federal Reserve officials—have been urging such a course since early this year. I was among the advocates of a tax increase then, and I feel the same way today. Of course a number of measures raising Federal tax receipts were put into effect this year, but these did not include a general tax increase. Unfortunately, besides the natural political reluctance to increase taxes, the proposal met with only a very lukewarm attitude on the part of business leaders in general, many of whom felt that higher taxes would merely be regarded as an "invitation to raise Federal expenditures". This never struck me as a logical position. It seemed to me to ignore the considerable efforts of the Administration to hold down outlays in many categories of nonmilitary spending—an effort that I trust will continue—and it represented a degree of defeatism on the whole application of fiscal policy which I was, and am, unwilling to accept. I have dwelt at some length on the failure of fiscal policy to do more to contain inflationary pressures over the past year, primarily because this provides a necessary background for my comments on the monetary situation.

Let me review very briefly the means by which the Federal Reserve traditionally influences the financial and economic position of the country. Essentially our influence is exercised through our ability to control, within limits, the rate of expansion of bank reserves. Since reserves are closely related to deposits, and since bank credit is the counterpart of bank deposits, this means an ability to influence the course of both bank credit and bank deposits. And since demand deposits are the major component of the money supply, we can include the latter among the economic variables subject to strong Federal Reserve influence. In connection with bank credit, I would like to point out that this is only one form of credit, with total credit flows of all kinds, originating largely in savings, greatly exceeding the flow of bank credit in any given period. Nevertheless, bank credit is a highly important component and often constitutes a marginal source of credit having great influence on the terms on which total credit demand and supply can be matched off. The Federal Reserve System is constantly trying to evaluate the expansion of total credit and bank credit, and various measures of liquidity, always having in mind the whole situation of the economy, in order to decide how much or how little restraint to place on the banks' reserve position.

We in the Federal Reserve are sometimes accused of a predilection for high interest rates. This I would deny categorically. Speaking for mystelf, I have a predilection for whatever level of rates is consistent with a balancing of credit demand and supply at a level that will aid in the achievement of our national economic goals. I would add an important proviso, i.e., that too rapid or extreme interest rate movements, or very exaggerated rate levels in either direction, can cause new problems of their own. A few years ago we were greatly troubled, for example, by the prospect of excessively low interest rates which would have had an adverse influence on our balance of payments. More recently, it has been fear of excessively rapid and sharp upward movements that has given us pause and has indeed been a principal reason for our seeking a helping hand from fiscal policy.

While rates can be influenced by the System, they are to a much greater degree the resultant of market forces. Frankly, most of us in the System were surprised by the amount and speed of the climb in interest rates in 1966, and especially in the summer of 1966—which is another way of saying that the force of credit demands was even stronger than we had expected. When the ceiling on time deposits under Regulation Q was set at 5½ per cent by the Board of Governors in December 1965, most of us thought merely that ample leeway was being provided to permit the free play of competitive forces, with little likelihood that actual rates would soon reach the ceiling. Yet the force of credit demands was so great that the ceiling was reached (on long-term certificates of deposit) within four months. For one thing, economic activity moved up much more rapidly than previously, with the Vietnam acceleration playing a crucial role and with business outlays on plant and equipment also contributing a major stimulus. With the speedup in the expansion of the economy came heavy credit demands, including those needed to support a larger investment in inventories and receivables, besides a growing investment in plant and equipment. While corporate cash flow was still rising, it was not doing so rapidly enough to meet all these needs. In fact, cash flow, which had slightly exceeded corporate needs in 1964, has recently been falling far behind these needs. To these "real" credit requirements was added considerable anticipatory borrowing, founded in the fear that interest rates would rise still further or that credit might actually become unavailable. By midsummer, we were beginning to feel that the limits of monetary restraint were not far distant. Interest rates had already reached such extreme levels (by historical standards) that they were contributing to a real fear of financial crisis; and this factor, in conjunction with the prospect of heavy Treasury financing, was acting as a stimulant to more anticipatory borrowing.

All of this was happening in spite of the fact that actual bank credit was expanding at a very substantial pace—something like 8 per cent per annum in the first eight months of the year, only moderately below the very rapid 10 per cent gain in 1965. In no sense was the economy being starved for credit by a tight-money policy. On the contrary, there was every reason for Federal Reserve policy to remain firm as we tried to check a credit expansion which was clearly too rapid in relation to the real growth capability of the economy on a noninflationary basis. Some have contended that the System should have pressed even harder through monetary policy in the first half of 1966, in order to prevent as sharp a bank credit expansion as actually occurred. While this sounds easy, my reply would be that we were indeed trying to step up our pressure on the banks' reserve position—for example, net borrowed reserves of the banking system increased in the first half of 1966 from around $50 million to $350 million—but the strength of credit demands was so great that, despite this pressure, bank credit continued to rise very rapidly. Moreover, if we had tightened reserve positions much more than we did, we would certainly have speeded the escalation of interest rates that was already giving us and the financial markets much concern. Although we had made it quite clear to the banks that the Federal Reserve would not provide the reserves to permit as large an expansion of overall bank credit as occurred in 1965, the banks apparently could not overcome their competitive urge to meet an excessive proportion of the credit demands of their good customers, including a fair amount of anticipatory borrowing. In fact, it apparently took considerable reeducation of commercial bank lending officers before banks could get their loan expansion in line with the resources that were available to them.

The System always must be, and is, conscious of its responsibility to help avoid disorderly market conditions and any serious threats to the general soundness of financial institutions. During the summer, many of us were surprised by the extent of loose talk in the market and in the press to the effect that the System was determined to press its restrictive policy "ruthlessly" and might even welcome crisis conditions in the markets. Actually, we were doing our best to walk a knife-edge; we were seeking to restrain excessive credit expansion while avoiding such heavy pressure or the development of such sharp or extreme market movements as to foster an atmosphere of panic. We were conscious of the fact that the banks, in their scramble to obtain funds to meet pressing loan demands, were tending to liquidate securities at a pace which the market could not sustain. While total bank credit was growing at an annual rate of about 8 per cent during the first eight months of the year, banks were on balance staying barely even on their investments while total loans were rising at an annual rate of over 12 per cent and business loans at about 20 per cent. It was largely to make clear our concern over this general situation that the System issued its statement of September 1, which included an assurance that we wished to see continuing growth of credit, but at an appropriate pace; that the Reserve Banks' "discount windows" were available, as always, to meet any seasonal or unusual pressures, including those caused by heavy deposit losses; and that we wished to encourage the banks to slow down the excessive growth rate of their business lending as a means both of reducing the rate of total bank credit expansion and of relieving very heavy pressures in the markets for municipal securities and other credit instruments.

We had shared the market's feeling of worry over a possible severe loss of deposits by savings institutions. This worry had become acute around midyear as the July 1 interest payment period approached. The actual experience was much better than had been feared, partly because of defensive rate increases put in effect by savings institutions at about the time of the interest date; and the loss of deposits at the October 1 interest date was less than it was at midyear. Since then, both savings banks and savings and loan associations have been showing deposit gains. Nevertheless, this continues to be an area of concern and to some degree a factor limiting the scope for monetary restraint. Of course the essence of the problem is twofold. Many of these institutions are locked into long-term assets, principally mortgages, to a very high degree and hold only a small amount of liquid assets. In contrast, the bulk of their liabilities are short-term and, in fact, are regarded by the holders as payable on demand (this view being encouraged by the institutions themselves). Thus the savings institutions were in a much less flexible position than the commercial banks when it came to raising deposit rates to meet the competition of other forms of savings media. They lack the commercial banks' flexibility both as to variety of investment outlets and as to possibilities for varying deposit rates among different types of depositors.

There can be all kinds of recriminations as to how so many of these institutions were allowed to become as vulnerable to general interest rate movements as they did; but the System has had to deal with the situation as it exists. Of course, there are other Government agencies that have a more direct responsibility for supervising and assisting the savings institutions. I very much hope that ways can be found in the coming years to strengthen the liquidity of certain groups among the savings institutions, and to establish a better balance of their assets and liabilities with respect to maturity. For the time being, the greatly improved atmosphere in the capital markets and the substantial decline in interest rates from the summer peaks have relieved the pressure on the savings institutions and removed fears of impending crisis. Taking a longer view, I think it is worth emphasizing that the Federal Reserve System has ample power, both through the discount window and even more importantly through open market operations, to make available whatever massive addition to bank reserves may be needed at any time to avoid a financial crisis, even if this should mean a temporarily greater growth of bank credit than we would choose to encourage on economic grounds.

Let me digress for a moment on Regulation Q. To begin with, I have real reservations about the desirability of fixing maximum interest rates by regulation (let alone by legislation). Like Chairman Martin and others in the System, and like President Kennedy's Committee on Financial Institutions in 1963, I have expressed the hope in the past that we might ultimately dispense with Regulation Q entirely, except as a standby authority for use in emergencies. However, I readily admit that a favorable opportunity to cut loose from the Regulation has not presented itself in the last year or so. On the other hand, I hope we shall not fall into the habit of assuming that the setting of interest ceilings is a normal and desirable practice for permanent application. In the circumstances of the last year, when bank credit was growing much too fast, and when the savings institutions were facing especially difficult problems, there was something to be said for using Regulation Q as a deliberate means of putting added pressure on the banks to reduce their rate of credit expansion, since the ready availability of certificates of deposits, at rising rates, had been a factor that had lessened the banks' sensitivity to reserve pressures exerted by the System. But there are distinct limitations to such deliberate use of Regulation Q as an instrument of general monetary policy. For one thing, it involves the System and other regulatory agencies in an almost hopeless task of deciding the "equities" among different types of institutions—commercial banks, mutual savings banks, savings and loan associations, etc.—when the "equities" might better be left to the decision of market forces. For example, the level of the interest ceilings on thrift accounts recently established for mutual savings banks and savings and loan associations raises questions with respect to the present 4 per cent ceiling on member banks' savings deposits. Furthermore, all our solicitude for certain classes of institutions cannot prevent market forces from diverting a large share of total credit flows to direct investment by lenders in market instruments, to the detriment of *all* financial intermediaries. This is exactly what has been happening in 1966, for example. While up-to-date statistics are not available, it is noteworthy that such direct nonintermediated credit flows were, as a percentage of total credit flows, more than twice as large in the first half of 1966 as in 1965. Beyond financing an increased share of private demands, the public also picked up an exceptionally large share of the heavy flow of new Federal Government and agency issues. If a given type of borrower wants credit badly enough and is willing to pay for it, he can always resort to borrowing in the open market. So the concept of using Regulation Q to discourage commercial bank intermediation and thereby to help the savings institutions is a path with very obvious limitations, both theoretical and practical.

The same general line of comment applies to efforts to use monetary policy as a means of allocating more credit to what may be considered socially desirable uses. To my mind, the emphasis on business borrowing in our September 1 letter relating to the discount window was fully warranted in the light of the need to restrain an excessive growth of bank credit. In the light of the extremely high rate of business loan expansion earlier in the year, it was virtually inevitable that an effective slowing of expansion in total bank credit would depend on a serious effort by banks to limit the pace of growth of this loan sector. Moreover, some banks had been so eager to raise funds to meet burgeoning loan demands that they had been liquidating certain types of investments at a pace that threatened the stability, and perhaps even the viable functioning, of the markets for certain types of securities. Under such conditions, a slowing of the growth of business lending seemed logical and essential, as many of the bankers themselves had explicitly recognized for some time. But I can see grave dangers in trying to go too far either with this specific emphasis on business lending or indeed with any emphasis on credit allocation in the application of monetary policy. On the first count, I can see serious drawbacks to placing too much of the blame for current inflationary tendencies on excessive business spending and, indirectly, on excessive lending to business. Admittedly, accelerated business expenditures on plant and equipment, as well as on inventories, have contributed importantly to the excessive level of aggregate demand. But it seems to me that a too stimulative Federal budget is also a major contributory cause; and in any case, it does not follow that the most desirable cure is a sharp and deliberate reduction in private plant and equipment outlays, whether through monetary or fiscal measures. After all, plant and equipment expenditures should make an important long-run contribution to increasing productivity and hence to offsetting upward wage pressures. It might prove decidedly better, from the standpoint of future price stability, to emphasize a slower growth in consumption as a means of reducing aggregate demand. As for the widespread solicitude over the decline in new housing construction for the past year, some of this is doubtless justified by the severity of the drop; but some considerable decline from earlier peak levels was probably a very useful means, in a situation of growing inflationary pressures, for releasing resources to other sectors, including defense, in which there has been a rapid run-up in spending.

More broadly, I believe monetary policy should concern itself with specific credit allocation only in exceptional circumstances, as when market pressures and critical institutional developments began to reach a danger point last summer. In my opinion, the Federal Reserve System's position of independence within Government would be seriously jeopardized if we were to make it a regular practice to try to influence the direction of credit flows.

It would hardly seem reasonable to discuss monetary policy with you without mentioning the discount rate and the administration of the discount window. On a purely theoretical basis, the discount rate should be higher than it is. On the other hand, there have been a variety of cogent reasons against increasing it in the circumstances prevailing in recent months. I am glad to say that the potentially excessive use of the discount window has not become a problem, partly because of "policing" by the Reserve Banks and partly because of the traditional reluctance of many member banks to get into debt at the window. This reluctance may have been enhanced by some degree of uncertainty now prevalent in the market as to the criteria of window administration, about which I shall say more in a minute. I do want to emphasize that changes in the discount rate have proven to be useful in years past, and that I see no reason to abandon this tool of monetary policy.

With respect to discount window administration, I believe the important point to emphasize is that the Reserve Banks are still running their discount windows under the terms of, and in accordance with the spirit of, Regulation A, as has been true for a good many years. The System's September 1 statement signaled a modification, in the form of a decision to use the incident of borrowing from the Reserve Banks as an occasion, along with other formal or informal contacts with member banks, to emphasize the desirability of slowing the rate of growth of business lending. This specific step to meet a specific set of circumstances—presumably temporary—does not, in my judgment, justify all the loose comment one hears about the "revolution" that is alleged to have occurred in the procedure for borrowing at the Reserve Banks.

In closing, I should perhaps say a few words on future prospects. As I said at the outset, this has been a year of great difficulty for the Federal Reserve, and I fervently hope that the problems of the coming year will be easier. There is no doubt in my mind that, after several years of relatively easy credit conditions, Federal Reserve restraint has really been "biting" in 1966. There is inevitably some lag in the effects of a tighter credit policy, so that we may still see further effects of our past actions over the coming months. In my view, the System has risen to meet its responsibilities to combat inflation—as it must if sound economic growth is to be achieved. And it has done so without losing sight of its responsibilities for the proper functioning of the financial markets.

At long last, there seems to be rather solid evidence that bank credit expansion has slowed materially in the past several months, which is of course much to be desired. In some degree, this slower credit growth may merely reflect a high level of borrowing earlier in the summer, both anticipatory and related to the speedups in tax payments. Certainly the continuing strength of the economy would suggest that credit needs will remain heavy for some time. I would hope, however, that the rate of bank credit growth would remain appreciably below the rate of the first half of the year. It is well to remember, too, that to the extent that the commercial banks are playing a smaller intermediary role because of the loss of certificates of deposit, a given shrinkage in the growth of bank credit does not signify as tight a general credit situation as would exist if this so-called disintermediation were not taking place.

I am sure all of us are pleased with the much greater stability that has characterized our financial markets in the last couple of months, with all that this means for the health of our financial institutions. Whether we can count on the continuance of this improved market atmosphere depends on many factors that are still uncertain, including future developments in Vietnam and the degree to which monetary policy will be working in an environment marked by appropriate policies in other areas of Government, especially the tax area. I have no doubt that the proper mix of fiscal and monetary policies can bring about a better balance in the economy and can assure a continuance of the more settled conditions that have recently prevailed in the financial markets. I am hopeful that all of us have learned something from the trials through which we have passed in the last twelve months. For it is only through enlightened cooperation among all elements of the economy that we can hope to approach those shining goals to which I am sure we all subscribe.