Coming Problems in the Control of Money and Credit*

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In the fourth century B.C., writing about the Peloponnesian War, Thucydides stressed the importance of "knowledge of the past as an aid to the interpretation of the future, which in the course of human things must resemble if it does not reflect it". Taking Thucydides' advice, I think a brief review of recent economic and credit developments should facilitate an understanding of coming problems in the control of money and credit.

Perhaps I shouldn't even use the word "control" because it assumes a precision that does not exist. However, the word was used in the title assigned to me by the program planners, and there it is in the title of my remarks. I would prefer to use the word "influence". The Federal Reserve System certainly can influence the amount, availability, and cost of money and credit.

Let us bear in mind that the control of money and credit, or the influencing of money and credit, is not an end in itself. It is a means of promoting our nation's basic economic goals of (1) maximum sustainable economic growth, (2) maximum practicable employment, (3) reasonable price stability, and (4) equilibrium in international transactions.

RECENT EXPERIENCE

The current unprecedented economic expansion began eight years ago. At that time there were substantial unused resources of men and equipment. By the beginning of 1965, this slack had been largely taken up. As unused resources were brought into use, economic growth expanded rapidly. Over the four-year period ended in 1964, we had an annual growth in gross national product of about 5½ percent in real terms, a reduction in the rate of unemployment from 7 percent to about 5 percent, and relatively stable prices. Unfortunately, however, we also had a large deficit in our international balance of payments. With this exception, we did pretty well in promoting our national economic goals. This achievement was fostered by a mutually reinforcing combination of fiscal policy and monetary policy.

But in 1965 inflation reared its ugly head. An escalation of military expenditures on top of a fully employed economy led to excessive aggregate demand. Unfortunately, as a nation we delayed in taking adequate steps to reduce the excessive stimulation that Federal Government expenditures were having on the economy. Prices rose at an accelerating rate. So did wages and unit costs of production.

At long last, in June 1968, after much damage had already occurred, the Congress enacted the Revenue and Expenditure Control Act of 1968 which provided for the surtax and certain spending restrictions. The legislation, together with other factors, is converting a $25 billion budgetary deficit in the fiscal year ended last June to an approximate balance of receipts and expenditures this year.

Upon enactment of the legislation last June, much talk was heard about the danger of economic "overkill"; there was fear that the restrictive effects of the tax and expenditure provisions would severely limit economic activity and might bring about a recession.

But consumers kept up their spending in spite of the tax increase; they reduced their rate of saving which previously had been much higher than normal. Residential construction and business investment continued to be vigorous. So was the demand for labor. There were many labor bottlenecks, and unemployment was very low. Inflationary pressures were stronger than they had been in

* An address before the financial conference of the National Industrial Conference Board, New York City, February 20, 1969.

years, and there was a strong inflationary psychology. Inflation stimulated imports and drastically reduced our traditional substantial international trade surplus. In 1968, the rise in consumer prices was 4.7 percent, the highest it had been since 1951.[1]

On the financial side, the demand for credit was very strong and interest rates reached their highest level in decades. Commercial bank credit had risen in the first half of 1968 at an annual rate of 6 percent, but in the second half it rose at a 15 percent rate. The money supply, i.e., currency and demand deposits in the hands of the public, rose at an annual rate of 6 percent in the second half of the year, while the money supply plus time deposits rose at a 12 percent rate.

In the first part of 1968, the main job of trying to dampen the inflationary pressures fell on the Federal Reserve, which pursued a restrictive credit policy. Although the Treasury normally retires debt in the first half of the year, it had a large deficit in the first half of 1968. Thus, it had to borrow substantially. Despite this development, the 6 percent annual rate of bank credit expansion in that period was about half as large as the rate of expansion in the year 1967.

By midsummer, however, the Federal Reserve eased up a bit in view of the new restrictive fiscal policy. In retrospect, one may question the wisdom of that action. By the year's end, however, the Federal Reserve was pursuing a more restrictive policy and has continued to do so.

Before getting into a discussion of the problems now confronting us in the control of money and credit, I would comment briefly on our international balance of payments. Our statistical record with respect to international capital flows was much better in 1968. Foreigners increased their investments in our stock market. Loans to foreigners and investment outflows were curtailed under the temporary Government programs administered by the Federal Reserve and the Commerce Department. And our Treasury made additional special arrangements with foreign monetary authorities under which more of their reserves were placed in less liquid form. Thus our recorded liquidity balance showed a small surplus, and our official reserve transactions balance showed a large surplus.

Let us not be misled, however, by these figures. There are limitations on a continuing flow of equity investment here by foreigners and on further special transactions with foreign monetary authorities. And it would be a grave mistake to make the foreign credit and investment restraint program permanent. Not only must we correct the deterioration in our traditional trade surplus; we must exert every effort to enlarge the surplus over the years.

Thus we still have an important balance-of-payments problem that requires our best efforts to solve. I trust that the improved balance-of-payments statistics for 1968 will not obscure the need and create a euphoria which can only worsen the long-run adjustment problem.

BASIC PROBLEM

So much for background. In this setting, the basic problem before us is how best to promote our national economic goals. More specifically, in the control of money and credit, we must seek:

(1) to reduce gradually, but steadily, the rate of price inflation,

(2) to do so without a substantial rise in unemployment or a recession,

(3) to bring to an end the current attitude of businessmen, investors, and consumers that inflation will continue indefinitely,

(4) to promote economic balance in our relations with the rest of the world, and

(5) thus establish a sound basis for healthy and sustainable growth.

In brief, these objectives will be promoted by checking excessive overall demand in the economy. On the supply side, we may reasonably expect the future to bring more efficient productive facilities; these should come from large investment, technological advances, and a larger effective labor force as a result of general population growth and better individual training. As these expectations are realized, production should increase to meet the economy's demands, inflationary pressures should subside, and stability should become a reality. Thus the main problem at this time is the proper restraint of demand without stifling it.

We should have no illusion that the transition from inflation to stability and sustainable growth will be easy. Nor can it be accomplished overnight. But the transition is essential for the long-run economic health of the United States.

FISCAL AND MONETARY POLICIES

Fiscal policy and monetary policy should work together, seeking to restrain overall demand without stifling it; they should support and complement each other. The

[1] In the period 1961-64, consumer prices rose only 1.2 percent per year.

nub of a compensatory fiscal policy is a budgetary deficit in a period in which a substantial portion of the nation's resources are idle, and a budgetary surplus in a period in which excessive demand presses on available resources. As we all know, in practice it has been easier to achieve a deficit than a surplus. In the current situation of excessive demand, fiscal policy should continue to do its part; it should avoid stimulating the economy. In my view, in the absence of extraordinary developments—and I don't see any—the income surtax should not be allowed to expire in June. I think it should be extended for another year, and that there should continue to be a close scrutiny of expenditures and a check on them. An effective fiscal policy will contribute to a reduction of pressures in the money and credit markets, and thus avoid placing an excessive burden on monetary policy.

Monetary policy must also do its part. As you know, the Federal Reserve discount rate was raised in mid-December to bring it back to 5½ percent, and since then there has been increased pressure on the reserve position of member banks.

The maximum rates of interest on certificates of deposit (CD's) and other time deposits under Regulation Q have been left unchanged despite a rise in interest rates on marketable securities and a substantial runoff in the amount of large CD's outstanding as CD's have become less attractive to investors.

From early December through the first week of February, large CD's declined by more than $3½ billion. This decline, of course, has put some pressure on the banks, but they have managed partly to offset these losses by tapping the Euro-dollar market. In the first five weeks of this year, Euro-dollar takings, i.e., the amount of advances by foreign branches of American banks to their head offices, rose by $2½ billion to $8½ billion. The rates paid for such funds have exceeded Regulation Q ceilings by a good bit, but of course such borrowings are exempt from interest rate ceilings and reserve requirements.

In 1966, after CD rates reached the Q ceilings in August, the total borrowings of Euro-dollars by the large banks rose by $1½ billion, an amount roughly half as large as the decline in CD's. Since 1966 the money market banks, which are the major source of business loans to large corporate borrowers, have vastly developed their capacity to tap the Euro-dollar market.

One of the problems in the control of money and credit is the use of the Euro-dollar market by American banks as a source of funds. There are indeed two aspects of the problem: (1) the role of Euro-dollars in the process of adjustment by the banks to pressures on their reserve positions, and (2) the effect of the increased use of Euro-dollars by our banks on interest rates in the foreign markets in which the Euro-dollars are obtained.

Flows of personal savings into financial intermediaries are also influenced by interest rate regulations. Although the proportion of income saved by individuals was lower after mid-1968, additions to savings accounts at commercial banks and thrift accounts at mutual savings banks and savings and loan associations were not greatly affected. When in 1966 the overall net intake of funds into the thrift institutions dwindled, residential construction declined dramatically. A number of the institutions, in fact, experienced sizable withdrawals. In this situation, special arrangements were made by the Federal Reserve to provide emergency credit assistance, but fortunately there was no need to use them. I believe that the thrift institutions have learned much from their experience in 1966. Then they had a good deal of "hot" money placed with them by customers who were highly rate conscious. Now they don't have so much hot money, and they are in a more liquid position. They are better equipped to handle a slowdown in growth of thrift accounts or even a decline in such accounts if such a slowdown or decline develops. Nevertheless, I would expect the Federal Reserve to provide emergency credit assistance in the unlikely event of a severe drain of funds that could not be accommodated through customary adjustment procedures.

Another problem is a highly intangible one, incapable of statistical measurement; it is the difficult problem of inflationary expectations. Monetary restraint should be sufficiently strong and clear to demonstrate to the public that for the United States inflation is not going to be a way of life. At the same time, Federal Reserve policy should not be so tight as to cause recession. I hope we can successfully steer this course between Scylla and Charybdis.

Over the last decade, as you know, a major consideration in the formulation of monetary policy has been our international balance of payments. We also have had to take into account the possible effect on vulnerable foreign currencies of changes in rates of interest in the United States and of pressure on the reserve positions of our banks. An important objective of monetary policy will be to help improve our balance of payments.

The most important thing that can be done at this time to improve our international position is to lick inflation at home. Reduction of excessive demand at home, and curtailment of price increases which have recently plagued us, should go far toward reducing the demand for imports, which rose at an unprecedented rate in 1968. At the same time, licking inflation should contribute to keeping our products competitive in world markets and should encourage greater effort to market our goods abroad and thus expand our exports.

As we struggle to stabilize the purchasing power of the dollar, we must be ever mindful, of course, that employment is an important economic goal. What is the best way to promote employment? Are very rapid increases in overall demand the only way? The experience of other countries has shown that, although the stimulus of excessive demand may temporarily reduce unemployment, the resultant inflation over the longer run reduces employment and creates severe hardships.

The National Industrial Conference Board help-wanted ad index is at a record high. For over three years our rate of unemployment has been at or below the 4 percent interim unemployment target set by the Council of Economic Advisers in 1961. The unemployment rate for married men at 1.4 percent is the lowest since these statistics were first collected in 1954. But the unemployment rate among white teen-agers (16 to 19 years, inclusive) is about 10 percent, and the rate among nonwhite teen-agers is more than 20 percent. Maintaining an excessive overall demand will not solve the problem of those unemployed persons who are inadequately trained or inadequately motivated. In this group different individuals have different problems. Much has been done in the last couple of years to provide training programs geared to the needs of particular individuals and to likely work opportunities. Much more must be done. This kind of attention to the problems of individuals in the ghetto is going to help them much more than keeping up an excessive demand for workers to fill jobs for which they cannot now qualify.

CREDIT GROWTH

Until it is clear that aggregate demand in the economy is under adequate control, you can expect the Federal Reserve to continue to seek to restrain the expansion of credit which adds to demand.

In the present situation, with the economy operating at practical capacity ceilings and with a pervasive inflationary psychology, credit should not grow at the extraordinarily rapid rate of last year. The shift of the Treasury from the role of a massive net borrower to a neutral position will, of course, reduce the demand for funds. But private demands, as well as state and local government demands, are large.

In the present economic setting the Federal Reserve will not supply sufficient reserves to enable the banks to acquire all the good investments offered them and to make all the loans requested of them by borrowers of good credit standing. This does not mean that the Federal Reserve wants to bring credit expansion to a halt; it wants to moderate the pace of expansion so that overall economic advance can be sustained but at a slower pace than has recently prevailed.

There should be no need for banks to dump good assets in an unreceptive market at unrealistic prices. Bankers and others learned much in 1966, I think, about the management of their assets and their liabilities. I think they are better equipped now to take, and are more aware of the need to take, appropriate steps to protect themselves from getting into a position where they must make drastic changes in their policies and practices without enough time for careful consideration and orderly decision making. If a bank finds itself in need because of an unusual loss of funds, or other special circumstances requiring temporary assistance, it has, of course, access to the Federal Reserve discount window. It is part of our job to be of assistance while a bank is making necessary adjustments.

Bankers and other lenders have already established higher rates of interest—a traditional method of discouraging borrowing. But rationing credit through rate alone is not likely to be sufficient. Bankers in general will no doubt conclude, as many have already, that they will have to be more selective in meeting loan requests. They will have to consider more criteria than merely the creditworthiness of the borrower. They will have to apply some order of priorities consistent with the time-honored necessity of serving the public interest and of balancing the interests of the banks' customers, depositors, and stockholders. Sometimes perhaps they will lend less than the borrower requests. This type of selective action by individual bankers, who have knowledge of all the relevant facts, should gradually and with minimum disruption reduce the temperature of our overheated economy.

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As fiscal policy and monetary policy work together and as private enterprise exercises self-restraint—as all of us work together—it should be possible over time to lick the inflation and restore stability and sustainable growth in our economy.