T I G H T M O N E Y

An Address by

Hugh D. Galusha, Jr.

President
Federal Reserve Bank of Minneapolis

at the
13th Annual Institute
University of Minnesota
School of Business Administration
Alumni Association

St. Paul Hilton Hotel
October 27, 1966

TIGHT MONEY

In a world that lives increasingly from moment to moment, with seldom more than twenty-four hours in full view, there is an understandable tendency to look upon today's problems as having appeared sometime shortly before we woke up this morning. Of course, this is not the case. Where we are today is always the result of a journey that started a long time ago. In this connection, it is a useful exercise to look back over the past at the signals we followed and shouldn't have, as well as those we didn't follow and should have. Failure to chart the right course may have been because some of the signals were only partly visible, some were not clear, and a few may even have been totally obscured, and visible only in retrospect. Hopefully, such an exercise improves the speed and accuracy of the identification of future signals; but at the least, it affords an opportunity to anticipate our critics and the major offenses for which they will seek to consign us to the limbo of discredited prophets. That there is seldom unanimity among the critics as to the precise nature of the missed signals is scant comfort. Yet, it seems to me, there are enough of the signals now clearly visible to justify the policy decisions made by the Fed over the last twelve months. Before discussing these policy decisions, it might be helpful if we look at some of the signals leading up to them.

Commencing in mid-1964, the money supply started to increase rapidly. This rate of increase levelled off a little at the end of 1964, and even took a downturn in May of 1965. But it then took off again at an accelerated rate.

Through October, the annual rate was 4.4%, but this included an annual rate for October alone of 9.5%. After a brief pause, it started its rapid ascent again, and in March reached a high point of nearly $172 billion. After faltering a bit for about six weeks, it made one more sharp spurt before starting to shrink to its present level, which is about $170 billion.

During this same period, total loans and investments of commercial banks showed a continued increase. This rate of increase, which had been fairly constant, has only recently begun to falter. Even more disturbing during this period, however, was the very sharp run-up of commercial loans at the major banks. In the fall of 1964, the rate of increase of commercial loans started to accelerate, and even though other types of loans showed a very modest growth, the rate of growth of this important component was enough to produce an over-all sharp rate of increase for total loans. For example, bank credit rose at an annual rate of 11.3% in October, and at an annual rate of 9.7% during the first ten months of 1965. This we must contrast with a growth rate of 8.4% during all of 1964. Business loans showed a decline in October, but the rate of growth during the first ten months of 1965 was 19%, which was considerably more than the 11.9% of 1964.

A different picture is shown by demand deposits. During the period of late 1964 to date, the average level of demand deposits has fluctuated about a fairly constant trend line. Although time and savings deposits grew fairly rapidly during the first part of 1965, they, too, started to level off as 1965 drew to a close. Real concern started to develop during the fall of 1965 about the ability of banks to compete with other financial intermediaries. An attempt to increase the prime rate had failed, and the banks were stuck at a 5% level. Through most of 1964, and by the end of 1965, bank rates were lagging market

rates generally. This was increasing the pressure on banks to make business loans, because it was obviously to the advantage of the strong corporate credit to go to the banks instead of to the market.

The surveys of business spending started coming in at higher and higher rates. The first survey reported in October of 1965 indicated a probable 8% increase in 1966 over 1965.

What were some of the other signs? Well, one of these was the very high rate of labor utilization. At the beginning of 1964, the rate of unemployment dropped below 5% for the first time since early 1960. As the downward trend continued, draft calls added downward pressure. In September of 1965, the rate of unemployment reached 4.4%, and anxious voices began to be heard as the scramble for the trained help increased in intensity. In the fall of 1965, the hours worked per week increased dramatically. With the increase in overtime, of course, came an increase in consumer spending, and consumer prices began to move. This movement, which started in about May of 1965, was at first discounted because of the supply factor in the other components - namely, food. This comfort did not last long, for the index, although moving at a lesser rate, continued to increase. The consumer price index stood at 108.5% in October, 1964; 109.3% on May 1, 1965; 110.1% on July 1, 1965; and 110.4% on November 1, 1965. Even that old reliable index, that of wholesale prices, broke away from its long period of stability and began to climb in early 1965. Between October, 1964 and October, 1965, it had increased from 100.8% to 103.1%.

And then there was the balance of payments. Although the voluntary credit restraint program was regarded as at least a qualified success, the attempt to improve our balance on goods and services was not. The improvement

in the second quarter following the settlement of the maritime strike did not continue. It became obvious that the pressure of consumer demand was reducing the export potential at the same time it was increasing the imports.

Of course, there was Viet Nam and the level of government spending. I recall that it was in August of 1965 that the Open Market Committee of the Federal Reserve System first began discussing Viet Nam in terms of a war. As the fall wore on, the rate of spending for Viet Nam increased. The rate of spending was then as difficult to determine as it is now, but it was obvious it was at a vastly increased rate from the earlier projections.

This, then, was the scene. But in addition to these tracks left by the economy in its steady acceleration, there was a deepening tone of emotional response. Intuitive responses are at least as important to money managers as they are to airplane pilots. There were strong feelings that the Administration would not be reporting a budget that would indicate a lower rate of spending, especially with the acceleration then under way in Viet Nam. There were those who felt that we should wait in any case until more numbers were in, including the budget. But the delay would have forced a postponement substantially after the first of the year, because of the Treasury financing plans. It is interesting that most of the criticism, however, was based on timing, rather than general recognition of the emergence of inflationary pressures. This was the background as the end of November approached.

What were the policy decisions made by the Fed which have contributed to the subject of my talk today? You will note the qualification in the word "contributed". The more complicated the world becomes, the greater becomes our desire to find single causes, to separate the world into good guys and

bad guys -- into simple shades of black and white. Few times in our history has one of our major institutions shifted so rapidly back and forth from the position of a good guy to that of a bad guy, and vice versa, as the Federal Reserve System has in the past twelve months. I am afraid our economy is much too complicated to permit such a simplistic view. We tend to think of the economy as a large basin in which the major ingredients are contained in a fluid state. Ideally, these ingredients flow easily to maintain a level of equilibrium and constantly even throughout the basin. By simply increasing or decreasing the flow of the particular ingredient through the various faucets feeding the basin, not only can the mix be varied, but the volume of the economy as well. Unfortunately, the flow of money and credit, like industrial development, employment, skilled help availability, and the many other economic ingredients, is not quickly and evenly redistributed around the economy, nor is the supply always in proportion to an ideal mix. As the relationship of the other components in the economy changes, so must the supply of money and credit. The control of the Federal Reserve System over the supply of money and credit is neither as precise nor as exclusive as its critics would maintain. After all, there are only four tools at the disposal of the System -- Open Market operations, the discount rate, the control of time deposit rates through Regulation Q, and reserve requirements.

Of these, the Open Market operations are the least visible and the most frequently used. By buying or selling government securities for the System account in the open market, the supply of bank reserves is either increased or decreased, and the loanable funds of the banking system are changed in direct ratio. These decisions are made daily in accordance with the state of the money market, the level of bank reserves, and all the rest of the economic indicators

that make up the bewildering matrix of the money market. Although the decision is made daily, it is in accordance with the spirit of a directive adopted about every three weeks by the Open Market Committee. As only one of the factors bearing on the condition of the money market, the action of the Open Market Desk often must be reactive rather than positive. Often, on particular days, the Desk is not free to move within even the very broad limits of the directive because of fears that its efforts, when combined with forces present in the market that day, might produce exactly the opposite effect desired by the directive. Generally, Open Market operations have been of a tightening order since early in the summer of 1965. That they did not produce the desired results quickly, and in fact appeared expansionary until mid-summer of 1966, is less a result of deliberate action than the climate in which Open Market operations had to be conducted. With such a vigorous expansion under way, the money supply pretty much had to increase rapidly; otherwise unprecedented levels of interest rates would have resulted.

Criticism of this period is now mounting, based pretty much on the performance of the money supply during this period. However, I hope that historians of another decade will support the statement that, for the most part, Open Market operations during this period were consistent with the stance of monetary policy. It simply was not possible for the Fed, as only one of the influences in the money market, to curtail the expansion process as dramatically as its critics are now saying should have been done. Certainly, it is questionable whether the tightening which did take place, partly because of the Fed's action and partly because of the continued growth in loan demand, could have been accelerated much more without the completely intolerable run-up of rates referred to earlier. As it is, the cry was heard with

increasing frequency as the spring wore on, that all we were seeing was high cost money, not tight money.

But back to tool number two, the discount rate. The discount rate is frequently referred to as a signal rate. Although its avowed purpose is to establish the interest rate to be paid by member banks on their borrowings from the Federal Reserve Bank of their district, it does indicate shifts in direction of monetary policy. It was obvious to all, as 1965 drew to a close, that the American banking system had worked itself into a blind alley. Something had to be done to free both the loan and the deposit rates. This was done December 5, 1965, when the discount rate was increased from 4 to 4½%, thereby freeing commercial banks to increase their loan rate. May I emphasize that the rate adjustments of the commercial banks to their customers was entirely a voluntary act on the part of the banks. By giving official recognition to the importance of restraining credit, the monetary authorities at one stroke established an operating climate in which the banks became free to act.

At the same time, Regulation Q - our third tool - was amended. This regulation sets the maximum rate which a member bank can pay on time deposits. This move was very important. Commencing in 1961, banks had placed increasing reliance on certificates of deposit to provide them with funds when they needed them to loan. The C.D. served as the banks' response to the competition for funds that developed with the increasing sophistication of corporate treasurers and the managers of other large demand deposits. Until the change was made in December of 1965, though, banks had been at a disadvantage, as market interest rates continued to move up during 1965. By increasing Regulation Q a full 1%, from 4½% to 5½%, it was hoped sufficient headroom

would be provided to restore banks to a competitive position. And they began to compete for funds with a vengeance. Other financial intermediaries, mainly savings and loans, were the principal sufferers. The supply of funds available for mortgage lending, particularly residential construction, began to slow up. While not the entire reason, this did contribute to the decline of residential construction that has continued to this year.

Unfortunately, the economy continued on its dizzy pace. Although there was some fiscal response -- namely, the tax bill signed on March 15, which suspended the decrease in excise taxes, and accelerated corporate tax payments -- it was not enough.

The Fed moved again with its fourth tool, the reserve requirement. As of mid-July, the reserve required against time deposits in excess of $5 million was increased from 4% to 5%. This was aimed at the larger banks - in fact, it affected something less than 1,000 of the more than 14,000 commercial banks in the United States. But it was these larger banks that had been swelling the commercial loan statistics because it was, of course, at these banks the largest proportion of U. S. deposits is held. The effect of this move as a real deterrent is at least arguable; although it did decrease modestly the interest margin between business borrowing and business lending. Its principal effect was probably that of a signal of worse to come if the basic credit situation did not change. And it did not. Therefore, the reserve requirement was increased again on August 17 on the same type of time deposit and the same category of banks. Meanwhile, "back at the ranch" - which saying has a very special application in this context - realignments were taking place among the various financial intermediaries. To say that the S & Ls were hurting is to put it mildly. Their anguish became not only vocal but loud. Although the Fed

moved in June to roll back the maximum rate that could be paid on so-called multiple maturity time deposits in an effort to curb the issuance of consumer-type C-Ds by banks, it was not enough. Even the fact that the rate of increase of time money in banks had slowed up appreciably, indicating they were not wholly to blame for the plight of mutual savings banks and savings and loans, was no deterrent to Congress. In September authority was granted to the Fed to set interest rate maximums for different sizes and kinds of deposits. Hopefully, by allowing reciprocal action by the FDIC applicable to banks that are not members of the Reserve System but are insured by the FDIC, and the Federal Home Loan Bank Board to do the same for savings and loans, rate changes will be coordinated among the agencies, and the competitive balance among the various financial institutions can be preserved on an orderly basis. Whether in fact this has been accomplished nationally is still questionable, but certainly it had one very pronounced local effect, and that is to enrich the various advertising media.

While not involving an official change in one of the four monetary tools mentioned earlier, the famous letter of September 1, 1966, from the district banks written at the request of the Board of Governors, should be mentioned. Rightly or wrongly, this letter implies that the rate of business spending is the prime target of current monetary policy. Remember, though, that the Fed can operate only with the four tools, and only one of these, the open market operations, is of general money market application. The other three -- the discount rate, Regulation Q, and reserve requirements -- are limited to member banks in the commercial banking system.

This letter referred to the use of the discount window and its availability during the threatened run-off of commercial bank time deposits. At

the beginning of this fall, we were looking at C.D. maturities in September of $5.3 billion, in October of $3.5 billion, and in November of $2.2 billion, out of total levels of about $18.2 billion. As the money market rates continued to go up in August, there was real concern that banks would be unable to hold these C.Ds. The problem has not emerged in the dimensions feared, but neither are we out of the woods yet. This letter was written to assure banks that the discount window would be open to them, to assist them through this period of potential declining deposits, within the spirit of the administration of the discount window established in 1955 in Regulation A.

Briefly, the conditions that must be satisfied, according to Regulation A, center around unexpected seasonal demand or unexpected declines in deposits. It was indicated, though, in this letter that use of the window by a bank confronted with severe attrition in its time deposits would be conditioned upon a showing of a reduction in business loans. To the degree that a case can be made that this was an attempt to selectively control our administration of bank credit, it is a departure from the spirit of Regulation A as it has been commonly understood. A debate is raging currently, and will continue to do so for years to come, I suspect, as to the propriety of this action. It must be admitted that banks did not rush to the window to get 4½% money with this condition attached to it. However, I think a case may be made by a future historian that it contributed to the slackening in the rate of business lending this fall, if for the opposite reason intended by the System. The distaste of banks to subject themselves to the type of scrutiny hinted at in the letter may have had much to do with the rearrangements of their loan portfolios now going on.

What has been the result of these actions? Certainly it must be conceded that the pace of inflation has been slowed. The sharp upturn in the consumer price index and the wholesale price index has been halted. The demand for loans has shown signs of easing. There has been some moderation in the escalation of money market rates. Most importantly, there have been postponements in corporate spending. There are signs that the expansion of American industry has been slowed. It took time to accomplish this. The increase in rates was certainly not enough by itself. Those of us who have dealt with American business are well aware that interest rates and taxes as specific business determinants are much more important on the supply side than on the demand side. Although it is true that the investor with funds to place considers both elements in making choices among investment alternatives, the businessman looking for funds is more concerned with the availability of money and the comparability of tax rates with his peers. After all, he must move ahead with his business. His alternatives are much simpler and fewer than those available to the broad spectrum investor.

However, changes in rates -- of both money and taxes -- and official concern of the Federal government and its various agencies, do go into the matrix of the emotional climate, and do help shape the over-all cumulative spirit of optimism or pessimism which affects business judgment far more than technicians care to acknowledge.

Whether these few indications of the slow-up in the inflationary surge of our economy that started its current phase eighteen months ago are short-term phenomena, or whether we may be looking at a period of comparative stability, I don't know and I'm not going to guess, but I certainly hope it to be so.

I doubt that monetary policy can do much more. A case can still be made for fiscal action. It would be fortunate indeed if Federal, state and local governments would take seriously the exhortations that have been directed to the business community to postpone building plans until there has been some resolution of Viet Nam. A tax increase to help carry the cost could still be appropriate.

For what monetary policy needs is a restoration of elbow room. I suspect that the reliance placed on this single instrument has suspended temporarily its future effectiveness. We have placed too much reliance on monetary policy. We are injuring the industrial and social capacity of 1968, 1969, and beyond; and we have put a disproportionate part of the economic cost of Viet Nam on a few industries. This is why I believe greater reliance upon fiscal policy was essential, and barring a sharp downturn in business levels, will continue to be. I would doubt that even if there is a modest shift in fiscal policy, the cost of money will fall very far. Projects are being postponed in this country. Building plans have been postponed, and outside the borders of our country exists an insatiable demand for funds, a part of which originates in the private sector, with the usual economic imperatives, but a much greater part in the public sector with political overtones. Balance of payments considerations alone will require rates that reflect world credit conditions. It is down the road a few years that our real challenge may lie. The desire to alleviate human misery and stimulate economic growth, both laudable and related objectives, must be geared to the capacity of our people and our economy to produce goods and services, profits, wages, and taxes, at a rate that will not destroy us in the process. It is an easy mistake to confuse the role of money and credit. After all, we have all of man's

post-barter history to prove how easily people and their governments can slide into failure by an unwillingness to recognize that national interest, high motives, and economic capacity are not necessarily in constant proportion. The temptation to open the spigot marked "money and credit" as a single cure-all -- or to close it for the same reason -- has always had a mechanistic appeal to those who view the economy as precisely and simply controllable. And if the spigot is being manipulated for motives that are beyond question, the challenger of the process somehow is labelled an opponent of the motive, which in an idealistic nation is suicide, indeed. This, then, will be the battleground of monetary policy in the future.