Economic Policy - The Path to Inflation, Depression or Growth

Talk by Darryl R. Francis, President,
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It is good to have this opportunity to return to Tennessee and discuss with you some monetary and banking problems of mutual interest to the Federal Reserve System and the commercial banking community. I am particularly glad to receive an invitation to outline some Federal Reserve policy actions in response to the course of the nation's economy.

This is a most appropriate time for such a discussion in view of the importance of 5 major developments during the past year.

(1) Nineteen sixty-six was a year of excessive demand for goods and services. Production and spending had risen for five consecutive years from the cyclical trough in 1960.

(2) Output of goods and services had approached its potential effective capacity early in the year. Unused plant capacity in manufacturing industries had declined to 9 per cent of the total, and unemployment was down to 3.9 per cent of the labor force.

(3) The excess demand for goods and services was translated into higher prices. Prices of consumer goods rose 3.7 per cent from late 1965 to October 1966. Wholesale prices rose about 3 per cent during this period.

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(4) In response to these conditions, monetary policy changed markedly.

(5) Interest rates, which had already increased in response to rising demand, rose to the highest levels in over 30 years.

With these developments in 1966 as the central theme, I propose in this discussion: (a) to consider the basic causes of the 1966 developments, (b) to examine more recent Federal Reserve and fiscal policies, and (c) to point out some widely-held misconceptions of Federal Reserve actions.

It is generally believed by most students of economic developments that monetary and fiscal policies are the two chief public policy factors which influence spending and total demand for goods and services. Some view fiscal policy as dominant, while others view monetary policy as more effective. Advocates of the fiscal policy view believe that a change of a dollar in Government spending or taxing may lead to more than a dollar change in total spending because of the impact of Government spending on disposable incomes of consumers and business. Changes in the incomes of these groups will in turn influence their spending. Monetary actions, on the other hand, are believed to influence spending through changes in such variables as the stock of money, interest rates, credit availability and

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liquidity. If the stock of money held by individuals increases or decreases relative to their desire to hold money, spending likewise increases or decreases.

With the aid of the fiscal and monetary tools of analysis, I shall take a few minutes to review the policies that led to the situation in 1966. First, I shall trace the course of fiscal actions.

The fiscal program of the Government became progressively more expansive starting in early 1961 and continuing until about mid-1962. The high-employment budget surplus, which is an estimate of the Federal surplus given current tax rates, and assuming economic activity unchanged, declined from $14.2 billion in the fourth quarter of 1960 to about $6.1 billion in the second quarter of 1962 (Chart I). The smaller the surplus or greater the deficit in this budget, the more stimulative the impact of Federal fiscal activities. The stimulative character of the Government's fiscal program during the 1960-62 period was caused mainly by rapidly increasing expenditures, but new depreciation guidelines and an investment tax credit provided additional stimulus to private demand.

From mid-1962 through 1963 the Federal Government's fiscal program became more restrictive in its impact on total demand; the high-employment budget surplus rose from $6.1 billion to $13.7 billion in the fourth quarter of 1963. The growth of Federal expenditures slowed, while high-employment receipts rose rapidly.

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In early 1964 the fiscal program of the Government again assumed a more stimulative role in the economy, primarily as a result of enactment of a tax reduction bill. The high-employment budget surplus declined from $13.7 billion in the fourth quarter of 1963 to $6.8 billion a year later. In the second half of 1964 and in early 1965, the high-employment surplus rose, and the budget became somewhat less stimulative. But beginning about mid-1965 and continuing through 1966, Federal budget policy was by this measure more stimulative to total demand than it had been for more than a decade. On a high-employment budget basis the Government operated at a surplus of only $0.2 billion during this period. The consolidated cash budget deficit (cash flow between the Government and other sectors of the economy) rose from about $4.5 billion in 1965 to an estimated $7.5 billion in 1966.

In summary, budget posture over this period moved from a relatively restrictive stance in 1960 and became progressively more expansionary through tax cuts, additional welfare programs, and expenditures on the war in Viet Nam. By 1966 it had become more expansive than at any time during the previous ten years.

The course of monetary policy over the years since 1960 may be traced on the basis of changes in the stock of money. In mid-1960, several months before the cyclical upturn, the money

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stock began rising moderately. From mid-1960 to mid-1964 the stock of money rose at a 2.7 per cent annual rate compared with an average 2 per cent rate in the previous decade (Chart II). From the summer of 1964 to the spring of 1965, money rose at an expansionary 4 per cent rate, and from the spring of 1965 to the spring of 1966 it went up at a very stimulative 6 per cent rate. Then from April through January of this year the stock of money declined on balance. In recent weeks the quantity of money may have again turned upward.

As a result of favorable monetary and fiscal policies, demand for goods and services began to expand in 1961 (Chart III). During the 1961-64 period, the economy moved steadily closer to its potential output. On the whole, the expansion was orderly, creating no undue problems of resource allocation or inflationary pressures. Consumer prices rose about 1 per cent per year, while wholesale prices remained stable. During 1965, however, with the relatively rapid expansion in money stock and the more expansive Federal budget, especially in the last half of the year, demand grew more rapidly. Again, most of the demand growth was matched by an increase in output until the closing months of the year. During most of 1966, however, the rapid increase in total demand significantly outpaced the ability of the economy to produce, and with the economy at virtual capacity, much of the increase in demand was translated into higher prices (Chart IV).

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In response to this situation, monetary policy was reversed in the spring. The money stock (demand deposits and currency) decreased at an annual rate of 1.5 per cent from last spring to January of this year, after increasing 6 per cent in the preceding year and at a 4 per cent rate from mid-1964 to April 1965. Typically, changes in the stock of money have had their greatest impact on economic activity after some time lag. During the last half of 1966 monetary policy tended to restrain economic activity, while fiscal policy continued expansive.

The net effect of these opposite forces was a reduction in growth of total demand to levels approaching the rate of increase of our productive capacity. Gross National Product in real terms is expected to show little increase from the fourth quarter last year to the first quarter this year. The industrial production index was down in January and is expected to decline further in February. Also, the utilization rate for manufacturing capacity was about 87 per cent in February, down from 91 per cent in mid-1966. Upward pressures on prices appear to have moderated, reflecting less rapid growth in total demand. Consumer prices increased at a 1.9 per cent annual rate from August to January, compared with a 3.7 per cent rate from October 1965 to August of 1966. Wholesale prices have declined since August compared with a 4.3 per cent rate of increase from October 1965

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to August. The recent decline in these prices is a reflection of price decreases in farm products and processed foods accompanied by only slight rises in industrial prices. With this moderation in demand, monetary policy in recent weeks has undertaken a more expansive role.

Now I shall discuss some general misconceptions by the public of the part played by monetary policy in the economy during the cyclical upswing and including 1966.

(1) First, there is a general view that monetary policy became more restrictive with the rising interest rates in late 1964 and 1965. You will recall that three-month Treasury bills rose about 3/4 of a percentage point in late 1964, remained fairly stable in early 1965, and rose another percentage point in late 1965 (Chart V). I contend that during this period monetary policy was relatively easy. For example, from June 1964 until December 1965, the stock of money rose at an annual rate of 5 per cent, and total bank credit rose at a 10 per cent rate (Chart VI). In comparison, during the ten years 1954-1964, the stock of money rose only 2 per cent per year, while total bank credit rose only 6 per cent per year.

The rapid increases in interest rates during late 1964 and 1965 thus reflect greatly increased demands for loanable funds as the nation's businessmen went to the credit market to get more loans in an attempt to satisfy the growing demand

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for goods and services. This rising demand for credit simply outpaced the quantity of funds flowing into the loanable funds market through savings and new increments to the money supply. Higher interest rates during the period thus resulted from a very rapid increase in demand for credit and not from any reduced rate of additional supplies. Monetary policy was quite expansive throughout the period.

(2) Second, many assume that the increase in the Federal Reserve discount rate in late 1965 was a major force tending to push up interest rates generally. Most of you will recall the increase in the discount rate from 4 to 4 1/2 per cent in December 1965. This action of the System was probably more widely discussed than any single System action since 1951. This discount rate change, however, was an insignificant factor in monetary policy, or in the determination of interest rates. It had little or no impact on either the over-all supply or demand for loanable funds, the forces that determine interest rates generally.

Monetary policy has certain targets or objectives in view which are determined independently of the volume or cost of borrowings from the Federal Reserve Banks. These objectives may be stated or they may simply be assumed. They may relate to money supply, bank reserves, bank credit, employment, spending, the balance of international payments, or other economic factors. Almost all however, involve the impact of monetary actions on the economy through changes in the volume of bank

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reserves or reserve ratios. Changes in the volume of reserves can come about through member bank borrowings from the Federal Reserve Bank and repayments of such loans, or through purchases and sales of securities by the Federal Open Market Committee. Reserves created in either case flow throughout the banking system and have a general impact on the economy. Thus, extended borrowings at Reserve Banks which add to reserves in sufficient quantity to have an excessive impact on economic activity, must be offset by open market operations. Since the target level of total reserves would have been provided without borrowing from the Federal Reserve Bank, we cannot say that such borrowings or the discount rate were factors in determining the total level of reserves, the stock of money, the volume of loanable funds, or any other monetary variable.

Instead of the discount rate change setting off the general interest rate spiral in late 1965, I suggest that the increase in the discount rate was a response to rising interest rates that had already reflected the rising demand for loanable funds. When short-term rates rise above the discount rate, it becomes profitable for banks to borrow from the Federal Reserve Bank for investment purposes. This type of borrowing, if it were to occur without offsetting actions, could nullify all other monetary controls. Thus, borrowing by individual banks for

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temporary reserve shortages must remain a relatively minor source of bank reserves which can be offset by other central bank actions.

Average daily borrowings from the Federal Reserve Banks were less than $0.5 billion in 1965. This is equivalent to about one-sixth of one per cent of the volume of all bank credit outstanding.

(3) The third misconception is that the decline of interest rates from the September 1966 peak until December reflected an easing of monetary policy. After rising sharply in the last half of 1965 and the first three quarters of 1966, interest rates declined moderately from September to early December and somewhat more sharply after early December.

I view the moderate decline in interest rates from September to early December as reflecting a decline in the price of loanable funds that resulted from a decline in demand for credit, rather than an easing of monetary policy. An expansive monetary policy would have involved higher growth rates of important monetary variables. Instead of the higher growth rates, however, the following movements of monetary variables occurred:

(a) The stock of money, which had been declining since the second quarter of 1966, continued down from September to

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December. Only in recent weeks has the stock of money possibly again turned upward.

(b) Total reserves of member banks, which had turned down about mid-1966 continued down at an annual rate of 3.5 per cent from September to December 1966. In contrast, reserves rose at an annual rate of 2.9 per cent during the ten years 1956 to 1966. Since December bank reserves have increased at a whopping annual rate of 19 per cent, which might indicate an expansive monetary policy, but which, I believe, up to now reflects in the main a provision of reserves to accommodate a reversal of money market flows which has resulted in a reflow of funds to banks in the form of certificates of deposit and other time deposits. Within the past week the ratio of required reserves on time and savings deposits has been reduced.

(c) Total bank credit declined at a very slight annual rate from September to December. In contrast, total bank credit expanded at an annual rate of 7 per cent during the ten years prior to 1966.

From these data I believe you will conclude that monetary policy, which had become restrictive in the second quarter of 1966, continued to be relatively restrictive from September to December, measured in terms of money supply, bank reserves, or total bank credit. With relatively low or negative increments

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to the money supply, assuming a fairly stable level of savings relative to income, the rate of increase in loanable funds was well below that of the decade prior to early 1966. With the lower rate of increase in loanable funds coincident with a lower rate of return on such funds, it is apparent that the rate of increase in demand for such funds declined concurrently with the reduced supply. Since December, however, monetary policy has attempted to become more expansive. The stock of money may have turned up; bank reserves have begun to rise at a relatively high rate, and bank credit has expanded rapidly.

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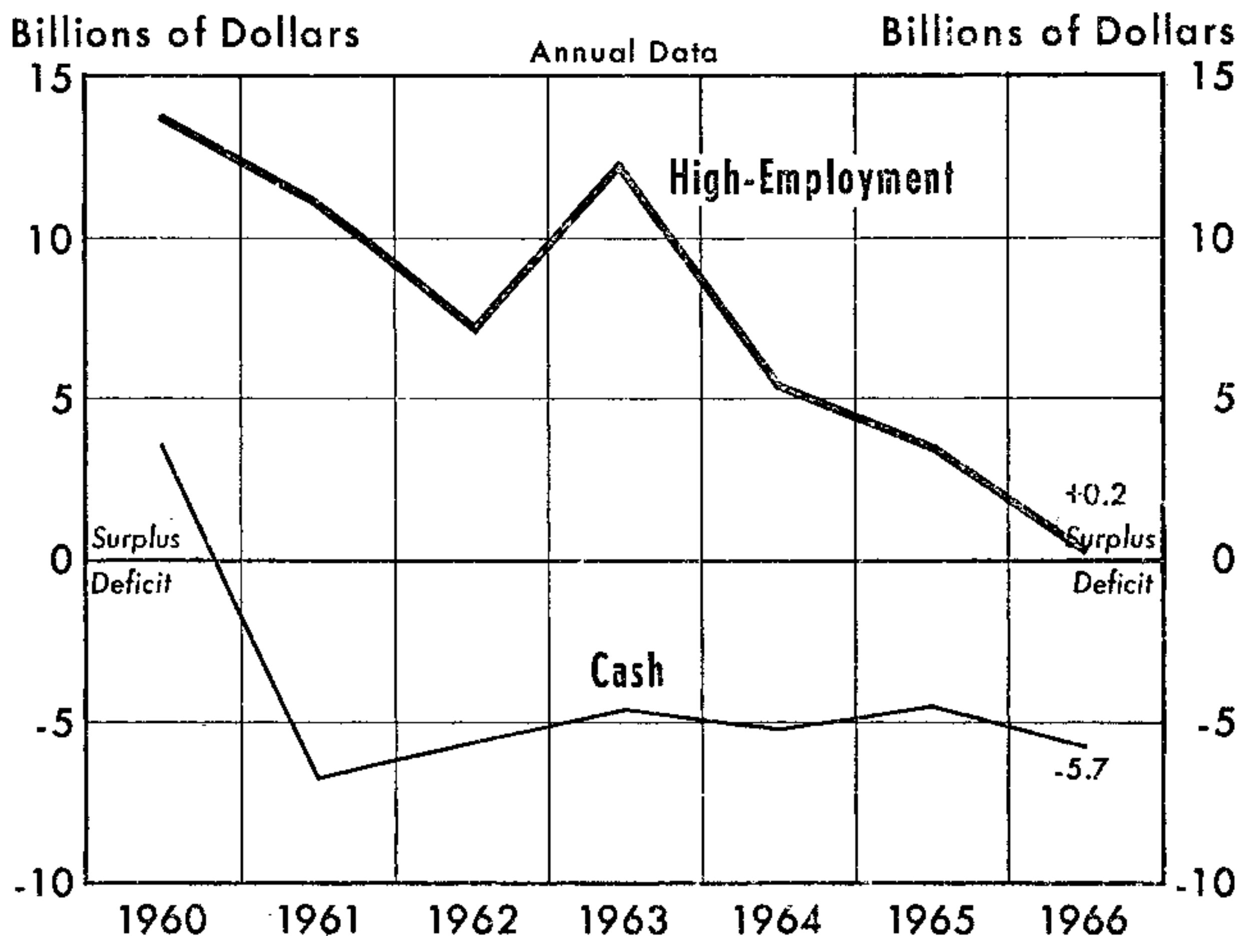

Sources: U.S. Department of Commerce, U.S. Treasury Department, Council of Economic Advisers, and Federal Reserve Bank of St. Louis

Latest data plotted: 1966 preliminary

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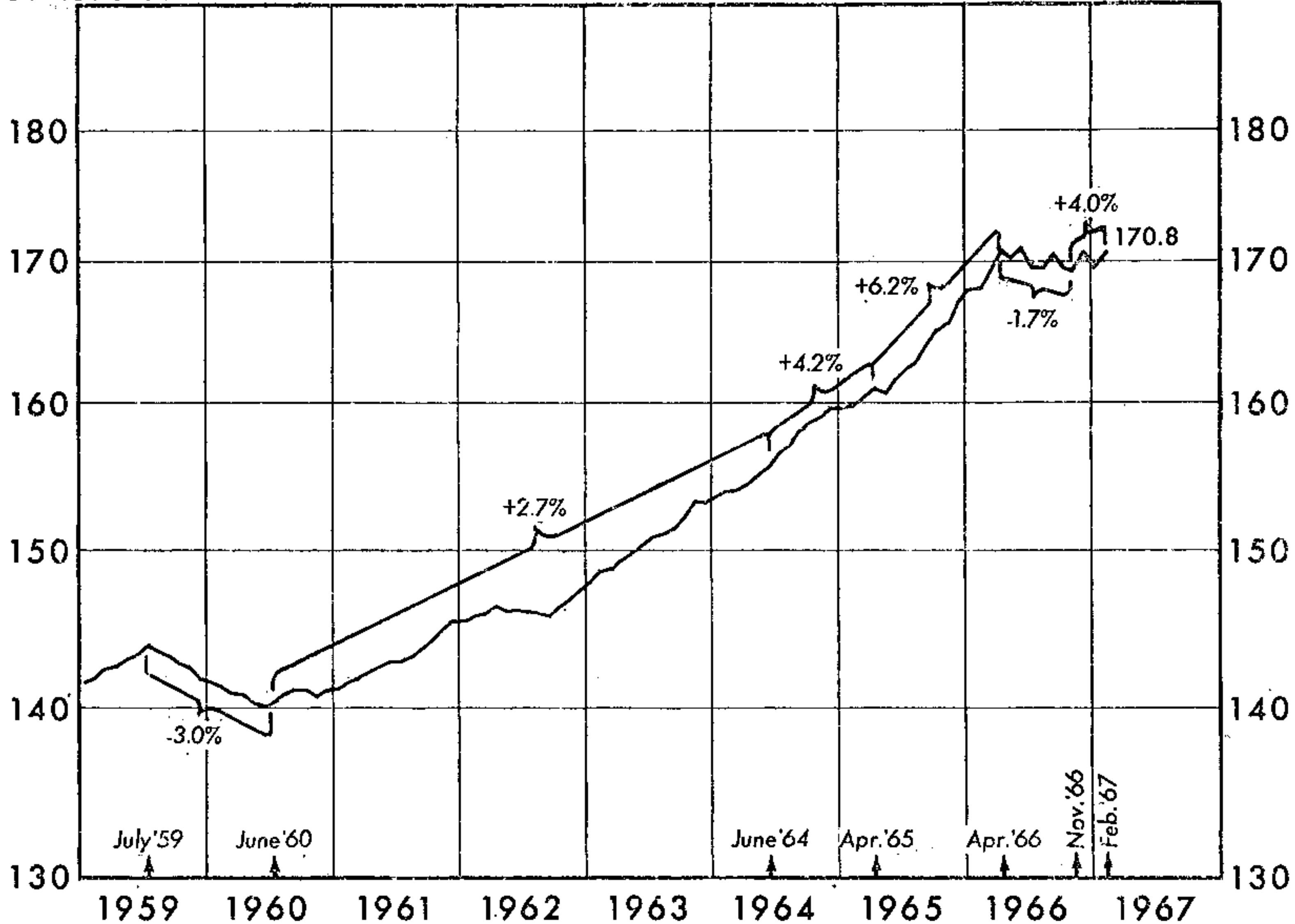
CHART II

Money Stock

Ratio Scale
Billions of Dollars

Monthly Averages of Daily Figures
Seasonally Adjusted

Ratio Scale
Billions of Dollars



Percentages are annual rates of change between months indicated.
Latest data plotted: February estimated

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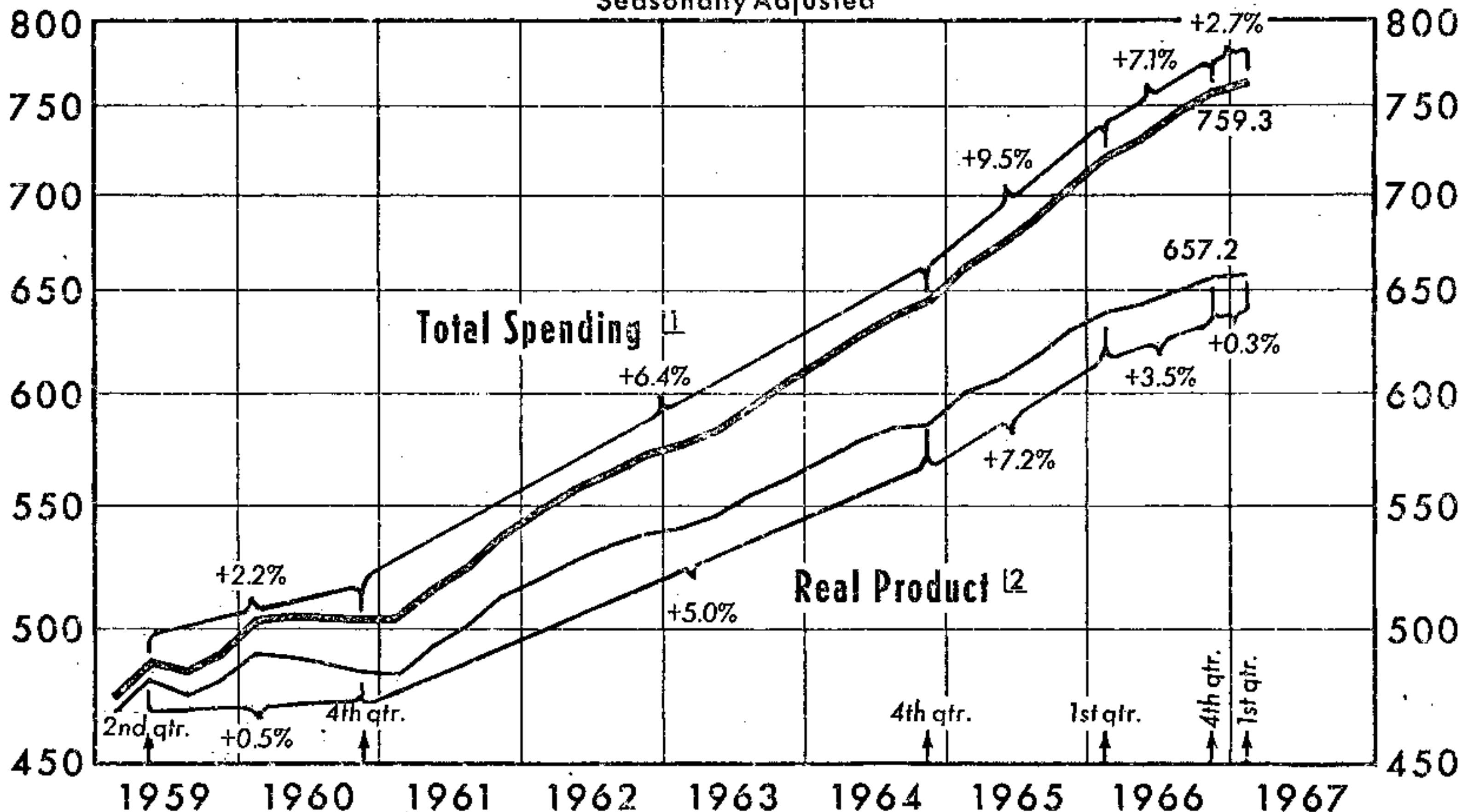
CHART III



[1] GNP in current dollars.
[2] GNP in 1958 dollars.
Percentages are annual rates of change between quarters indicated.
Latest data plotted: 4th quarter 1966
1st quarter 1967 estimated

Source: U.S. Department of Commerce

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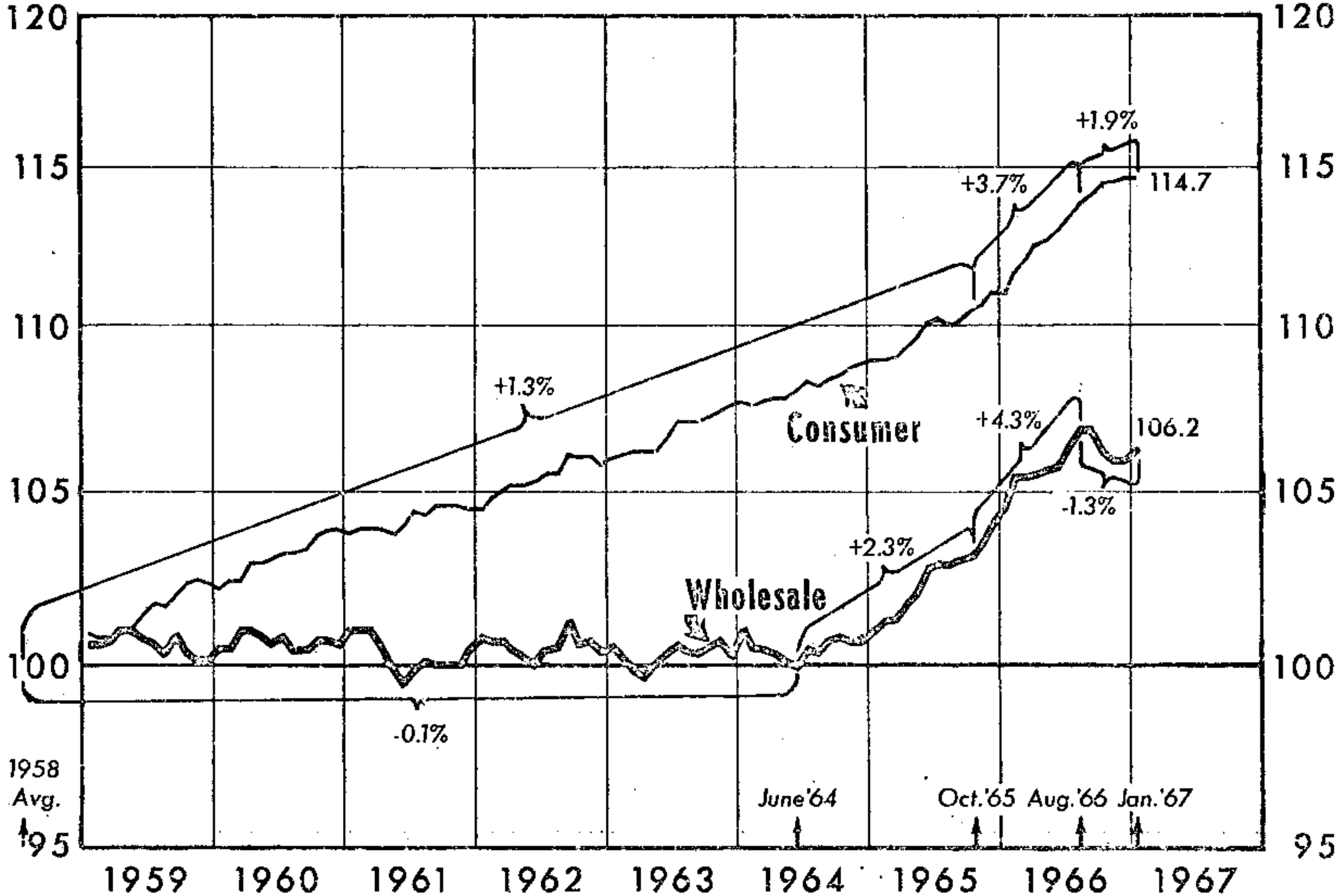
CHART IV



Percentages are annual rates of change between months indicated.
Latest data plotted: January preliminary

Source: U.S. Department of Labor

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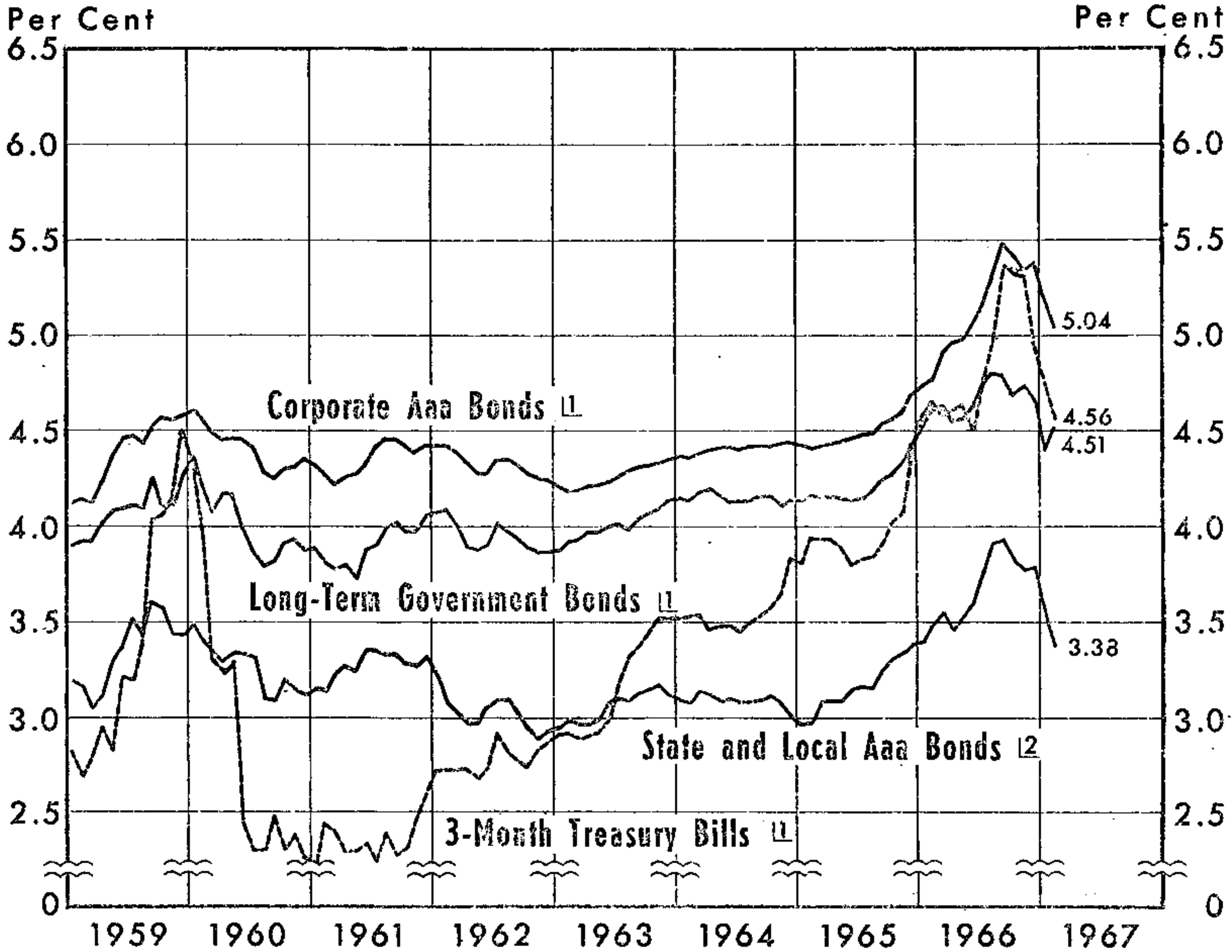
CHART V

Yields on Selected Securities



1 Monthly averages of daily figures.

2 Monthly averages of Thursday figures.

Sources: Board of Governors of the Federal Reserve System and Moody's Investors Service

Latest data plotted: February

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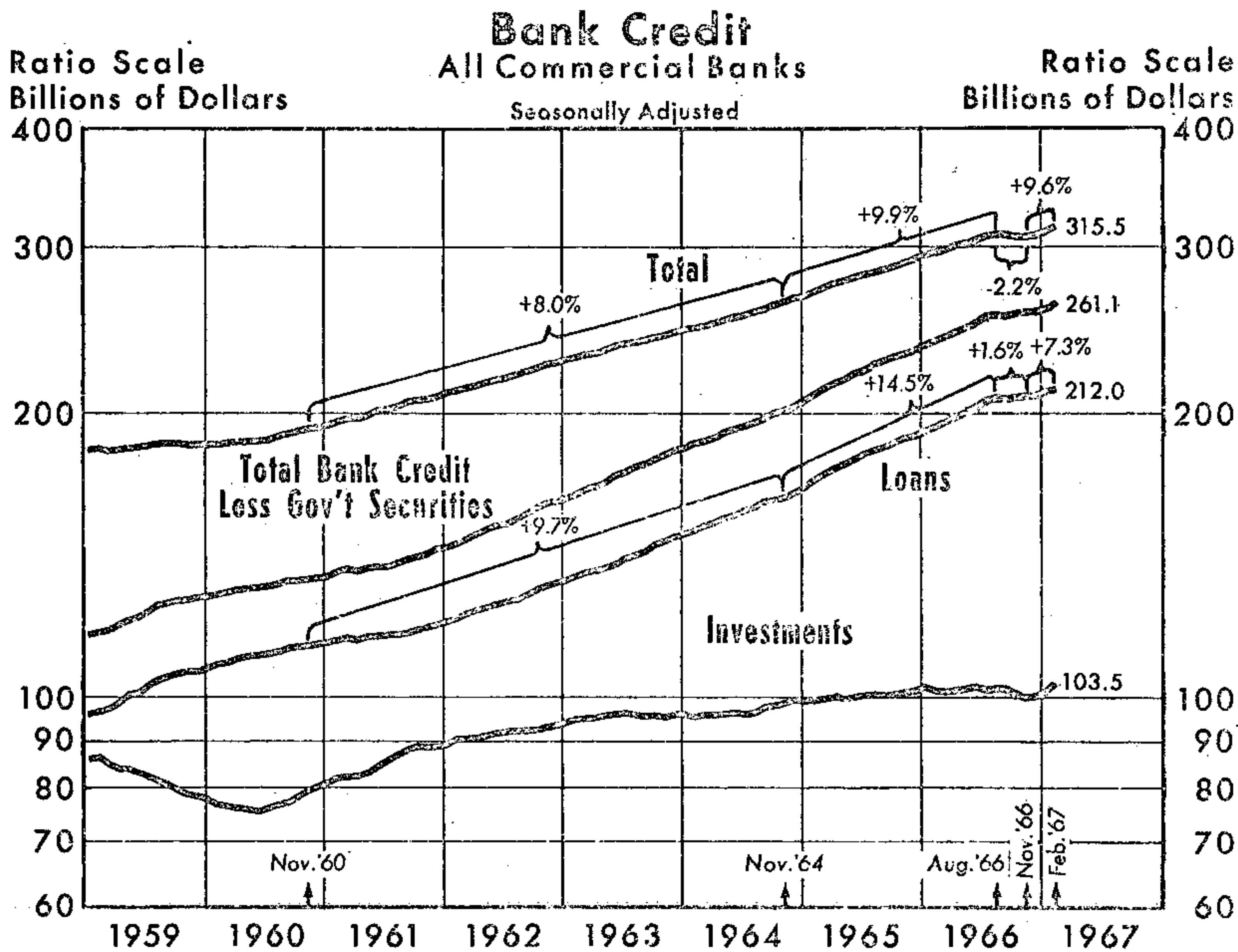
CHART VI



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