Prospects and Problems for Monetary Policy

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Once again it is a pleasure for my associates and me to meet with our good friends of the New York State Bankers Association and to have this opportunity to exchange views on matters of mutual interest. I recall that when I saw you a year ago we were hopeful that 1972 would show substantial economic improvement over the preceding year. Clearly that hope has been fulfilled, and I think we can look forward to another year of substantial progress, although we shall still have plenty of difficult problems to wrestle with.

Before taking a closer look at the current economic and financial scene, I would like to spend a few moments on some matters having to do with the payments mechanism. A recent development in that area of considerable importance to the banking system was the change in Regulation J requiring payment for checks in immediately available funds on the day of presentment—a change which became effective November 9 of last year. The revision in the regulation has caused banks to give us a substantially larger volume of checks to collect for them. As a result, we experienced some transitional problems, and our transit service to our member banks dropped well below the standards of efficiency and speed that we have tried to maintain. Most of these difficulties are now behind us, I hope, and the banks and their customers are benefiting from earlier payment for checks received and from earlier knowledge of unpaid items.

We have also completed the conversion of the Clearing Bureau on Long Island to a full-fledged Regional Check Processing Center (RCPC), thus improving the payments system in that area. We are working with a committee of the Long Island Bankers Association on a study of establishing an Automated Clearing House, which would enable the banks there to reduce the volume of paper by using magnetic tape. They could then explore the feasibility of payroll deposit, point-of-sale terminals, and other SCOPE-type activities as market demands may suggest. As many of you know, our Buffalo Branch serves as a regional check center, processing and collecting overnight items drawn on all the banks in the Branch territory. In New Jersey, we are establishing a North Jersey RCPC; among the benefits to banks in New York State will be a much later deposit deadline and faster return of unpaid items.

Our next step, for which the analysis and planning are under way, will be the establishment of a regional check center in upstate Head Office territory. A preliminary study of check volume and flows, of transportation routes, and of available labor supply suggests that the center may be located in the vicinity of Utica, but it's still too early to be sure. As soon as we complete our study, and receive the suggestions of an advisory committee of bankers in the area affected, we will make an announcement of the place and the time we expect to begin operations.

As you can see, significant changes are taking place in the payments system. These changes will have important effects on the way banks and their customers do business, effects that will play a part in shaping the banking structure of the state.

Now I would like to offer a few comments on the state of the economy and some of the problems on the horizon for monetary policy. The present business situation is marked by considerable strength, with the economic expansion showing substantial forward momentum on virtually all fronts. Moreover, there is every prospect that

this momentum will be sustained through this year. It is reasonable to expect some slowing in the current rapid rate of advance after mid-1973, although this becomes more uncertain as business optimism spreads. On this score, the achievement of peace in Vietnam could exert a stimulative influence on economic activity.

Employment has been growing very rapidly, and unemployment should drop further, although large increases in productivity and in the labor force may make progress here fairly slow.

Since 1965 inflation has been the most stubborn economic problem the nation has faced, but here too we have seen real progress in the past year. Wage and price increases moderated somewhat during 1972, and inflationary expectations were reduced. Moreover, the Administration is mindful of the fact that the anti-inflation fight is "unfinished business", and it is aware of the dangers that could lie ahead in the way of excessive stimulus from the Federal budget deficit.

Liquidity is ample, both among individuals and in the corporate sector, as well as in the banking system. Thus conditions are favorable for consumer buying and business investment, and the fears in some quarters of a credit "crunch" have receded in the face of credit demands that are likely to be manageable, partly reflecting this ample liquidity position. I would hope that this relatively well-balanced credit situation will continue. There is no cause for complacency, however. While rapid money and credit growth earlier in 1972 gave way to more desirable moderate gains in the late summer and fall, over the past month or so the rates of increase in the aggregates have again stepped up. Of course, the changes made last November in Regulations D and J have made it unusually difficult to interpret the data on aggregates since then, but the developing situation bears close watching.

As might be expected in a period of vigorous economic expansion, short-term interest rates tended gradually higher through much of the past year, with some more rapid increases toward the year-end and in early 1973. In recognition of this development the Federal Reserve System a week ago raised the discount rate ½ percentage point to 5 percent. Long-term rates, on the other hand, were notably steady through most of the year, doubtless in good part because of a lessening of inflationary expectations as well as some moderation in the demands for funds in the capital markets.

Faith in the dollar in international markets, while by no means fully restored, has improved markedly over recent months—primarily, I believe, because of the much better record in this country than abroad in combating inflation, but also as a result of the renewed spirit of economic cooperation among the major industrial nations.

On balance, I have probably painted a rather rosy picture so far; but like all central bankers I am paid to worry, and there are enough problems on the horizon to banish any feeling of complacency:

(1) Unemployment, even if reduced to less than 5 percent over the coming year, will remain sufficiently high to constitute a serious social problem and a source of strong continuing pressure for remedies. This will be true especially because of the very uneven distribution of unemployment by race, age, and geographic area. But this uneven distribution itself is one of the reasons why it is difficult to accept the popular notion that the remedy is to be found largely through expanding aggregate demand. Such a solution would be particularly dangerous as the use of resources approaches capacity and bottlenecks begin to show up in specific industries. The official goal of 4 percent unemployment originally set back in the early 1960's still commands widespread allegiance, despite the fact that changes in the age and sex distribution of the labor force would suggest a rather higher figure now if in fact 4 percent was appropriate a decade ago. Indeed, in the light of the experience of recent years, and given the present structure of the economy, it is clear that maintenance of a noninflationary environment at a 4 percent overall unemployment rate is not an easy matter. To say this is by no means to concede that the nation must passively accept socially undesirable levels of unemployment. It does mean, however, that much more vigorous and imaginative efforts are needed to attack "structural" unemployment through more efficient fitting of available workers to available jobs, better training, and perhaps measures such as modification of minimum wage requirements for young workers. Such reforms would provide much greater hope for a sustained reduction in unemployment than would excessive monetary stimulation leading to chronic inflation.

(2) The Federal deficit for fiscal 1973 seems to carry considerable risk of too much stimulus at a time when private demand is climbing rapidly and when unused resources, especially those of skilled labor, will probably be approaching a minimal level. The Administration is pledged to holding Government spending this fiscal year at or close to $250 billion, and I fully support that aim. Especially serious is the longer range budgetary outlook, because the automatic growth of existing programs—let alone any new spending commitments—will generate sizable increases in spending for the next several years. A reappraisal of national priorities to avoid straining our resources is overdue. Of course a reduction in military outlays would provide some room for important social programs, but I have no idea whether this is a likely

development. And it may well be that higher Federal taxes, reversing the trend of recent years, will have to come if we are to meet essential social needs and at the same time to escape a new cycle of escalating inflation and financial strains, with which monetary policy would find it difficult, if not impossible, to cope.

(3) Another significant uncertainty has to do with the effectiveness of the wage-price control program in Phase Three. I was heartened by the basic decision of the Administration to retain controls, and am hopeful that the program will bring further progress in dampening the forces of inflation. It has been my view right along that we should "play the string out" and maintain firm restraints until price and wage increases and inflationary expectations have been brought down to acceptable levels. Otherwise we may find that the past year's achievements in the way of dampening inflationary tendencies will simply have been thrown away, as demand pressures gather momentum. The prospect of a large number of major labor negotiations this year itself suggests the need for continuing surveillance. Of course no system of controls can be effective if aggregate demand pressures are allowed to get out of hand.

(4) The growth of bank loan commitments at a time when lending volume is already high is an area of concern that has important implications for System supervisory and monetary policy. Information that we have suggests that outstanding loan commitments to commercial and industrial firms at many banks have been expanding rather sharply. I recognize that it is natural for banks to expand their loan commitments during an economic recovery such as we have witnessed in the past two years. Yet, the ratio of unused commitments to total loans at many banks is probably high by historical standards, at a comparable stage of the business recovery.

Given the strength of business activity that we are likely to witness in coming months, we can expect to see some increase in the rate of borrowing against these commitments. Indeed, a number of bankers have indicated that they believe takedowns will accelerate over the course of 1973. While such a development may not be cause for concern, clearly an unexpected surge in the use of outstanding commitments could pose liquidity problems for some banks. Moreover, the efforts by banks to obtain funds to meet these commitments—as well as to accommodate other demands for credit—could create strains and pressures on financial markets. For this reason, we are focusing increasing attention on the volume of loan commitments extended by individual banks in relation to their ability to meet potential demands for funds.

I would add that restraint by the management of individual banks in extending loan commitments could serve to head off pressure for specific regulatory measures in the deposit or loan markets, and might also pave the way for removal of some of the existing constraints. I have indicated on numerous occasions that I would like to see the complete removal of Regulation Q ceilings on large-denomination certificates of deposit. Certainly, it would be easier to remove the ceilings if the System were confident that a scramble by banks for funds to meet loan commitments would not result in a sharp escalation of market rates. I think you will agree that self-restraint by bank managements in granting loan commitments is preferable to interest rate ceilings and other types of regulatory actions.

(5) Finally, current popular and political attitudes toward interest rates must give us pause. As I said earlier, pressures in the financial markets in recent months have been gratifyingly moderate. However, as the business expansion continues, it would be natural to expect increasing credit demands. Under such conditions, if the Federal Reserve acted to limit credit and money supply growth to a moderate pace, that might necessarily involve higher interest rates. If boom conditions develop, higher interest rates would have useful effects in themselves in providing a dampening influence on excessive spending.

Central bankers are not enamored of high or low interest rates as such. They are enamored, however, of rates that are free to fluctuate up as well as down to reflect underlying economic and financial conditions and an appropriate measure of credit availability. What is too often overlooked is that interest rates, because they fulfill this pervasive and essential overall economic function, are quite distinct from costs or prices of goods, services, and labor. Naturally certain interest rates are very significant costs to individuals as well as to corporations and governments. But if rising interest rates are regarded under all conditions as merely another sign of inflation and are opposed for that reason, their value as an equilibrating and moderating influence can be vitiated. There are situations when stable interest rates conflict with price stability. I am impressed by the wisdom of the Committee on Interest and Dividends in resisting pressures to subject interest rates in highly competitive financial markets to the same kind of control program that was applied to prices and wages. Perhaps it would be well to remember, too, that interest rates are unlike almost all wages and prices in that the latter tend to rise and seldom come back down to their earlier levels, whereas interest rates clearly move on a two-way street. This fact in itself should give comfort to those who find it hard to accept the usefulness of rising rates at a time of rapid economic expansion.

Another area in which interest rates can have significant effects is that of international flows of funds and the bal-

ance of payments. When we talk of better coordination of national monetary policies to help achieve a more stable international financial system, this means some degree of willingness to let comparative levels of interest rates among industrial nations have some influence on national monetary policy when domestic considerations permit. While domestic factors require high priority, this international aspect cannot be overlooked if monetary policy is to live up to its full potentialities.

I am quite aware that widespread antagonism to high or rising interest rates is a fact of life under almost any conditions, and of course especially during a period when wages and prices are subject to Governmental restraints. As I have already indicated, I think it is incumbent on all of us to make the wage-price program work. In these circumstances the exercise of responsible self-restraint by lenders with respect to interest rate increases is especially desirable. Bankers generally seem to have recognized the force of this argument.

Nevertheless, I believe that all of us who are deeply interested in the economy's functioning would do well to set as one of our primary long-run objectives an educational effort to persuade the public and political leaders that interest rates play a rather special role in the economy. Unless we succeed in making progress on this front, it will become increasingly difficult to maintain a soundly functioning central bank; and to the extent that monetary policy were impaired, the nation would be sacrificing its most effective and flexible tool for achieving the overall economic goals to which we all subscribe.