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Statement of

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Two problems--slack growth in the domestic economy and an adverse balance of payments in our international accounts--now occupy the stage of economic policy discussion. Not so many years ago, a persistently rising price level and an apparent dollar shortage in the world economy were the dominant problems of such discussion.

Though the problems have changed, the tools to deal with them are unchanged: fiscal policy, monetary policy, and structural alterations in particular institutions, practices, or programs. The mix of these alternative and complementary approaches depends on varying judgments of their relative efficacy and on the current economic environment and outlook. In my remarks today, I want mainly to focus on the recent role of monetary policy in coping with both problems and to suggest in very general terms the role that monetary policy might play in the developing situation.

Much of the commentary on the recent performance of the U. S. economy has noted that 1962 was the most prosperous year in our history. This is true but not especially notable. Real output per capita rose during the year but one per cent. Total output increased less than three per cent from the end of 1961 to the end of 1962 even though we had excessive unemployment and idle plant capacity throughout the year.

At the same time, the continuing deficit in our balance of payments acted as a constraint on efforts to stimulate higher levels of domestic economic activity. A trade surplus of about $5 billion was exceeded by our payments abroad on account of private capital, military outlays, and foreign aid. To reduce this deficit is a most pressing problem for the year ahead.

Business Outlook

At the moment, it seems to me that the immediate economic prospects are favorable--more favorable than for some time past. Spurred by the excellent public reception of the 1963 model cars, retail sales rose substantially in the fourth quarter, and consumer demand generally now appears more vigorous than at any time during 1962. Government purchases, especially at State and local levels, are clearly destined to continue upward, under the pressure of our defense, space, and international requirements and the needs of our rapidly growing population. Total construction expenditures have been running at record highs, and the recent volume of contract awards suggests a continued high-level of construction activity in the period ahead.

The expansion in final sales, if continued, should soon call for a higher rate of industrial output and should serve to augment business demands as well. Business inventories, for example have changed very little in recent months, but, with final sales up strongly, some restocking to accommodate a larger volume of business may now be in order.

The outlook as regards business capital outlays is more doubtful. The rate of expansion in such outlays last year was disappointing, reflecting mainly the lack of pressure on existing productive facilities, and the official surveys project a small decline in the current quarter. But operating rates in many industries have been inching upward, and it seems to me that the combination of rising final sales, continued high-level profits, and the considerable incentives provided by the tax credit and accelerated depreciation actions last summer and the prospective tax reduction for this year should give renewed impetus to investment plans and outlays as the year progresses.

The basis for accelerated economic expansion which I have sketched here owes much to the dramatic turn in business and public psychology which followed the quick and successful conclusion of the Cuban crisis. Since then, the pronounced recovery in stock market prices, the more buoyant attitude of consumers revealed by recent surveys, the strength in new car sales and housing starts--all point to a marked improvement in the business tone. It is important to note also that the stimulating effect of tax reduction on consumer buying and business investment plans will be buttressed by the record increase last year in public holdings of liquid assets and by the ready availability of credit on relatively favorable terms.

I have characterized the balance of payments problem as a most urgent issue. I say this because delay in its solution increasingly exposes us to pressure from our creditors and because it inhibits our freedom to stimulate a sluggish domestic economy, which has performed below par for several years.

I fully agree with those who say that we cannot neglect either the domestic or the international problem as we pursue a solution to the other. On the other hand, the two problems may call for different types of solution.

In these circumstances, what contribution can monetary policy make to achievement of fuller use of domestic resources and to improvement in the balance of payments?

Monetary Policy in 1962

The bare financial facts usually used in an evaluation of monetary policy over the past year are as follows: While GNP in current dollars rose about 4 per cent, bank credit--that is, total loans and security holdings of commercial banks--increased about 9 per cent. The money supply, narrowly defined as currency and demand deposits, increased about 1-1/2 per cent, but time and savings deposits went up 18 per cent. The rate of turnover of the money supply increased about 8 per cent. Market interest rates were relatively stable over the year, as long-term yields crept downward and short-term rates edged up.

On the surface, these facts are conflicting in that (1) bank credit and time deposits rose by large amounts and this would seem to indicate that monetary policy was strongly stimulative; but (2) the money supply rose very little for the year as a whole, and not at all until the fourth quarter, and its rate of use increased sharply, suggesting that monetary policy was not actively expansionary. When analyzed in the context of other developments during the year, these facts seem to me to show that monetary policy was inhibited throughout much of the year by balance-of-payments considerations and was less stimulative than was appropriate to the domestic situation.

All of the monetary and credit magnitudes for 1962 were significantly affected by the upward movement a year ago in the interest rates paid on commercial bank time deposits, following the change in the Board's Regulation Q. In order to interpret and appraise monetary developments during the year, it is vital to disentangle the various effects of this change, which enabled commercial banks to attract a large inflow of time and savings deposits.

Where did these time and savings deposits come from? Do they represent in effect a net addition to the community's stock of money, which the public chooses to hold as time rather than as demand deposits? Or, does the buildup in time deposits reflect a rechanneling of the flows of saving, as the public decided to hold more of its financial assets in the form of interest-earning deposits at commercial banks and less of its financial assets in the form of securities and deposits in other institutions?

I believe it is correct to say that a sizable fraction of the buildup in time and savings deposits at commercial banks last year simply represented a shift in the public's attitude toward the commercial bank as a financial intermediary. We know, for example, that individuals acquired a considerably smaller volume of State and local government bonds and corporate stock in 1962 than in earlier years, even though their total savings increased. It is reasonable to think that as individuals reduced their purchases of securities, they put the funds into time and savings deposits, on which interest payments were now higher. Similarly, corporations acquired a substantial volume of newly available negotiable certificates of deposit at commercial banks in 1962. These funds, too, would presumably have gone directly into Treasury bills and other short-term securities if they had not gone into commercial bank time accounts.

What happened, in other words, was that, to a degree, the public chose to invest indirectly through acquiring commercial bank time balances rather than directly by purchasing securities. The banks' role as financial intermediaries between savers and credit markets was thereby enlarged. To the extent that this happened, the resulting increase in total bank deposits and total bank assets should not be regarded as constituting monetary expansion or as contributing to total credit expansion. Rather, it represented merely a rechanneling of the financial flow of funds, as the public exchanged securities for bank time deposits.

Another portion of the increase in commercial bank time deposits includes funds that would have gone into other savings institutions if commercial banks had not raised their rates. Although deposits at mutual savings banks and shares at savings and loan associations increased substantially in 1962, they might have gone up even more if commercial banks had not become more attractive as savings depositaries. Here again, to the extent that commercial banks increased their role as savings institutions at the expense of these other outlets for savings, the resulting increase in bank assets and deposits does not represent injections of new money and credit into the economy.

Finally, there is no doubt that the advance in bank interest rates induced some individuals and business corporations to shift from demand deposits to interest-earning time deposits at commercial banks. That is, the attractiveness of a prominent near-money asset was enhanced and the public was thereby induced to economize further its holdings of cash balances. Or, to put it differently, as bank credit expanded in 1962, the public found it desirable to place the monetary counterpart of the credit expansion into time and savings deposits. To the extent that such conversions occurred, our comparative statistics on money supply fail to take into account the increased substitution of time for demand deposits.

It is unfortunate that we are unable to measure and compare these various components of the buildup in time deposits. All we can say is that the growth of <u>total</u> bank credit and deposits exaggerates the degree of monetary stimulus in 1962, while the growth of money supply understates the contribution of monetary policy to economic expansion. Let us, therefore, examine two other variables that usually express the extent to which the economy has been supplied with new money and bank credit.

The turnover of demand deposits, a measure of the velocity or rate of use of money balances, has trended upward in the postwar period. If we look at the cycles around this rising trend, we find that they conform rather well to the business cycle. We also find that turnover has generally increased faster in years of monetary restraint and slower in years of monetary ease. In the year just ended, the rate of turnover rose by as much as it did in some earlier years of vigorous economic expansion and restrictive monetary policy. I take this as an indication that the public has not been supplied with redundant amounts of new money in relation to its transactions and income.

This observation is confirmed by what happened to interest rates in 1962. As I noted earlier, short-term rates crept up during the year. Although long-term rates sank a little, they remain high by historical standards. Reflecting, as they do, the interaction of the supply of funds with the demand for funds, interest rate movements in 1962 reveal to us that the supply was not pressing very strongly on demand.

All in all, therefore, I would characterize monetary policy in 1962 as having been passively responsive to the bank credit and monetary needs of the economy but not actively stimulative. And this judgment is borne out by the fact that it was not until the final quarter of the year, when business and consumer psychology strengthened and business loan demand picked up, that money supply rose. It was at this point that the economy overtook the monetary posture of supplying reserves on terms consistent with a short-term rate pattern based on balance-of-payments considerations.

Could monetary policy have done more to encourage economic expansion in 1962? I believe that the answer is "yes" but judgments may differ on this--and particularly would they differ as to the consequences on the balance of payments. The range of difference is not very wide and would not cover, so far as I am concerned, a sufficiently aggressive monetary policy to have single handedly restored the economy to full use of its resources. As far as long run growth is concerned, the major contribution that monetary policy can make is shortening the duration, and cutting down the amplitude, of cyclical downswings and extending the period and amplitude of upswings. The secular tilt of the economy is more appropriately the concern of fiscal actions and structural reforms.

Balance of Payments Considerations

Just how is monetary policy constrained by balance-of-payments considerations? Since 1961 the objective has been to maintain a level of short-term interest rates in the United States that is tolerably competitive, exchange risk considered, with the level of short-term rates in other money markets, mainly in London and, to a lesser extent, Western Europe. This competitive level has succeeded in limiting, though not eliminating, incentives that U. S. banks and corporations, or foreigners with short-term dollar holdings, would otherwise have to add to the U. S. balance-of-payments deficit by switching from short-term dollar investments to short-term investment abroad.

Flows of funds of this kind are sometimes interpreted by important dollar holders, domestic as well as foreign, not as rate-conscious money seeking gain from interest differentials, but as the consequence of apprehensions about the strength of the dollar. Thus, monetary policy has in effect been directed at maintaining a psychology of international confidence in the dollar.

This is a perfectly proper objective for monetary policy to pursue but it is not one that can have a significant impact on correcting whatever basic imbalance exists in our trading-investing relationships with the rest of the world. And it is only through changes in these basic factors that a real solution to the problem can be achieved. Can monetary policy also play a role here? First, as to investing relationships.

A number of domestic and foreign observers have noted that our international transactions on current account and Government economic aid have in fact given rise to nearly equal U. S. payments and receipts in recent years. In consequence, they have identified our deficit on all transactions with our deficit on private capital account. They have argued that in order to bring our over-all payments flows into balance, we must sharply reduce net outflows of private capital. They have thought this result might readily be accomplished by a tightening of monetary policy and a rise in interest rates.

I would not deny that reduced credit availability and higher interest rates might not have some significant and lasting effects in reducing net capital outflows. They could; but much depends on the circumstances. In the economic environment of today, my judgment is that it would take more monetary action than is desirable to significantly curtail net capital exports.

The largest outflows of U. S. capital represent direct investments by U. S. corporations in foreign branches and subsidiaries. Basically, these investment decisions must take into account the relationship between long-term interest yields on market investments and the prospective profit yield of a particular investment. If credit conditions in this country should tighten as a result of vigorous, but non-inflationary, domestic economic expansion in which the relative profitability of investment in this country was rapidly improving, then indeed U. S. firms would invest more at home and less abroad, and foreign capital, too, would be attracted here. But if last year's climate of less than vigorous growth, with some slack in resource use, were to continue and credit conditions were tightened by restrictive monetary policy alone, a large retarding effect on the direct foreign investments of U. S. business could only be significantly effective at the expense of declines in other closely linked sectors of the domestic capital markets and therefore domestic expenditure.

Other flows of capital are probably more responsive than direct investments to changes in credit and interest rate conditions, but some of these flows, too, are less responsive than is often supposed. Much foreign borrowing last year, for example, through bond issues in our markets--the second largest category of capital outflow--was by foreign governments whose demands for external funds were not very flexible because they could find no other international capital market open and able to accommodate their transactions. Also, a good deal of lending abroad by U. S. banks was associated with U. S. exports whose financing could not readily be transferred to foreign credit markets.

Furthermore, it can hardly be argued that reduced credit availability and higher interest levels could have big effects on international capital flows but only minor effects on domestic credit flows. To have tightened monetary policy last year enough to have exerted significant restraint on those outflows of capital that are responsive could, in my judgment, also have had a strong braking effect on the lagging domestic economic expansion.

How could monetary policy be used to improve our basic trading position--to make our exports of goods and services more competitive? There is traditional orthodox prescription for a certain situation. The classical case for the application of "monetary discipline" so called, is that in which a country is suffering from excess demand and is attempting to deal with the twin phenomena of inflation at home and a deficit abroad. Here monetary restraint has the dual purpose of tempering the climate of the domestic economy and reducing the deficit in the international accounts. But our current domestic problem is not one of inflation but of lagging expansion and to attack the balance-of-payments problems with stringent monetary measures would risk imposing a costly drag on an already sluggish pace of economic growth.

Thus, the role of monetary policy can be, under present circumstances, only of limited effectiveness in dealing with the basic balance-of-payments problem just as it is of limited effectiveness in dealing with the domestic problem of lagging long run economic growth.

In the past two years a good deal of direct attention has been given to the conditions and environments which can be altered to improve our basic international economic position--through the reduction of tariffs, lowering of barriers to capital outflow by other high-savings industrial nations, the tieing of foreign aid, and the fuller sharing of free world burdens for mutual security. But the situation fails to show the degree of improvement needed to clearly indicate to the rest of the world our capacity and intent to reach an equilibrium payments position. We probably should be giving consideration to alternatives that up to now have been rejected.

For example, we might consider a more direct attack on the capital outflow problem. The United States has the largest and most accessible capital market in the world, and it ought to be kept free of exchange restrictions. It is proper and desirable that capital-poor developing countries should utilize this market to meet a portion of their enormous needs for foreign capital. It is not so clear, however, that it is either necessary or desirable for advanced countries, with balance of payments surpluses, to have recourse to our capital market on the recent large scale while they restrict and hamper entry of outside borrowers to their own capital markets. If these countries are unwilling to open their capital markets, possibly we should look toward tax measures that might help to remedy this unbalanced position. In general, we need to explore the possibilities of various tax measures that might, consistent with our obligations as an international good neighbor, and with the status of the dollar as a world reserve currency, discourage capital movements that appear to flow "uphill" to countries that are already capital-rich.

We also need to explore the possibility that tax measures might be used to encourage exports. As a matter of principle, there is no good reason why our exports should bear U. S. taxes. Taxation is a means by which we pay for government services. Why should foreign purchasers of our exports help to pay for the services provided by the U. S. Government to its citizens and why should our exporters be expected to be so competitive that their product prices have to absorb U. S. as well as foreign taxes and tariffs?

It may be that foreign countries in their tax policies also discriminate against their nationals' exporting activities. This is not easy to ascertain given the complication of various national, State, and local tax laws and conditions under which tax burdens are shifted to customers. But the discrimination against exporters of our country can hardly be doubted.

Monetary and Fiscal Policy in the Year Ahead

If the proposed tax reduction is successful in stimulating more rapid economic expansion, bank credit and monetary needs will in all likelihood accelerate. Business demands for loans will increase, consumers will impose larger calls on credit markets, and the Treasury will be financing an enlarged deficit. In such circumstances, the supply of bank credit and money can increase without downward pressures on interest rates and aggravation of capital outflows. In fact, bank credit, the money supply, and interest rates might well rise more in relation to advancing GNP than in comparable periods of expansion. This is so because monetary expansion has lagged during the past year. The fact that deposit turnover or velocity has continued to rise rapidly over the past year suggests that we cannot count as much as in other recent periods on past monetary creation to satisfy future monetary needs.

As to the question of how the enlarged budget deficit will be financed, I see this as a problem that can only be considered in the economic environment in which it occurs. The budget went into deficit during the recession of 1960 and, just as the recovery in the economy has been incomplete, the restoration of balance in the budget has been incomplete. The past year's deficit has been successfully financed outside the banking system.

The proposed tax cut will enlarge the deficit, but gradually rather than all at once. In view of the purpose of the tax cut, which is to stimulate the economy, a consistent national policy would hardly call for monetary action to offset its effects if the economy continued to operate well below its capacity. Similarly, if excess demand develops, generating inflationary pressures and psychology, offsetting action by the Federal Reserve would be clearly appropriate. Thus, the economic climate at the time should determine the posture of our monetary policy. In judging monetary policy in relation to deficit financing, what matters most is not whether the banks or the nonbank public purchase the securities to finance the deficit, but whether the economy as a whole is provided with a volume of money and bank credit consistent with sustainable expansion at relatively stable prices. This is not to say that the Treasury does not have a debt maturity problem. Its market offerings need to be fitted into a balanced structure of maturities. In financing an enlarged deficit, the Treasury may find it necessary at various points to compete with other borrowers in the different maturity sectors of the market. Under the economic environment that we hope to achieve, the competition may prove to be strong and the Treasury should be prepared to meet it.

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