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New Challenges for Monetary Policy

Remarks of George W. Mitchell

Member, Board of Governors of the Federal Reserve System

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New Challenges for Monetary Policy

Managing money is an age-old function in man's recorded history. Yet the powers of monetary action are periodically confronted by new challenges, or old challenges in new guises. I should like to discuss today two major developments of the sixties that are testing, and will continue to test, the wisdom and judgment of the monetary authorities and the effectiveness of the policy instruments that they use. These developments are the elevation of the U.S. balance of payments position to a major consideration of public policy and the culminating trend toward the transformation of liquid savings into illiquid assets.

In the emergence of both these challenges, we see the once passive becoming active. Until the late 1950's, the U.S. balance of payments was not a major consideration for monetary policy. While affected by and affecting other Government policies--witness the Marshall Plan and all that went with it--the external position of the dollar could be assumed by the monetary authorities to take care of itself. That has certainly changed. Similarly, bank deposit behavior was not regarded as an active element in the considerations facing monetary policymakers. The traditional view was that the Federal Reserve exercised its powers over the volume of bank reserves, and both bank credit and bank deposits reacted accordingly. This too has changed, now that banks have become pre-eminent in the transmutation of liquid savings.

I turn, first, to examine the challenge to monetary policy and monetary instruments presented by the balance of payments.

It is ironical that an unfamiliar constraint on monetary policy should appear at about the time when we as a nation were raising our sights as to what constitutes adequate performance of the economy, and especially as we were trying to enlarge the role of fiscal, monetary and other public policies in improving that performance.

But not only did the constraint appear; in some quarters it was heralded as a long overdue purgative for a flabby over-indulging dollar. That this was a temporary, if not a superficial, diagnosis became apparent as year after year in the expansive sixties our sales of goods and services exceeded our purchases by never less than $2 billion, and in 1964 by as much as $4-1/2 billion. Parenthetically, I direct your attention to the fact that these were gains without including our net earnings on foreign loans and investments. If we were undersold it was not on an overall basis as trading surpluses piled up year after year.

But, of course, there is more to the balance of payments than trade. As it turned out, our gains on trade account were offset in the areas of aid, economic and military, and private capital flows. Here it is instructive to note that had we limited our aid and capital transactions to the shipment of real resources abroad we would never have encountered balance of payments deficits. However reassuring that speculation may be, our problem has come to center on a deep and continuing concern that, if interest rates in the United States diverged too far below rates abroad, capital would flow out in such excessive amounts as to accelerate the depletion of our gold stock and threaten the stability not only of the dollar but of the international monetary system.

The constraint on monetary policy that I have just described is one of a family of constraints that would limit our monetary sovereignty. The question I would like to raise with you is whether it is appropriate to submit to this infringement on our monetary sovereignty--by which I mean the full use of our monetary policy instruments to encourage adequate performance of the U.S. economy.

In order to prevent misunderstanding, let me immediately assert that I do not believe our interest is best served by severing economic relationships with the rest of the world. I value as much as anyone the benefits of a free flow of goods and services internationally as well as the unrestricted flow of productive capital from areas where it is plentiful to areas where it is scarce. The problem is to achieve these benefits without the offsetting cost of less-than-adequate performance of the U.S. economy--a cost that would be borne not only by the United States.

If we are to respond properly to the challenge that the balance of payments presents to monetary policy and to public policy generally, we must fully understand the character of our balance of payments problem. It cannot be said too often that what the United States has been facing is not a classical, textbook-type external deficit. We are not living beyond our means, trying to consume more than we produce, and in the process spilling excess demand over our borders to the rest of the world. On the contrary, we have in recent years consumed domestically (in the broad sense of absorbing resources for consumption, investment, and governmental use) less than we have produced. And we have produced less than we could have produced. Our stable price level and our surplus of exports over imports (which, incidentally, has increased again recently) provide incontrovertible evidence to me that the United States has an extraordinarily strong competitive position and currency. In these circumstances, it is difficult to understand, let alone accept, the simple prescription that the way to deal with our balance of payments deficit is to tighten our belts by tightening monetary policy.

Having said what our balance of payments problem is _not_, let me now say what it _is_. It derives from the dimensions of our aid programs and especially a rising private capital outflow.

There are many reasons for the tendency of U.S. capital to flow abroad in large volume. Much of the recent increase has gone to developed countries--those in Continental Europe plus Canada and Japan--countries whose ability to provide the facilities necessary for the transformation of saving into investment has lagged behind their burgeoning economic growth and the strengthening of their currencies. In Europe, the Common Market, which was growing rapidly and was in the process of creating a free-trade area, offered attractive investment opportunities to American business. In Canada and Japan as well as in Europe, there has been a distinct tendency for growing demands for funds that accompany economic growth to spill over and converge on the U.S. capital market and U.S. banks. And, quite properly, U.S. institutions have been more than ready to respond to these demands.

I think it may be a mistake to ascribe the strong tendency for U.S. capital to flow to Europe to the same sort of a structural shortage of saving there as exists in the developing countries. That analysis is correct only in the sense that Europe has experienced excess demand while the United States has suffered from inadequate demand during much of the 1960's. In a cyclical sense, investment has tended to exceed saving in Europe and to fall short of saving here. What is a shortage of saving, after all, but an inability to divert enough of current output from consumption to investment so as to provide for a growing and technologically advancing capital stock. In less developed countries, the resources so lacking tend to be pulled in from abroad, if external financing is available. But in Europe, where capital formation has been high as a proportion of current output and where the trade balance has tended to be in surplus more than in deficit, the major problem would not seem to be inadequate saving.

Rather the problem to a large extent is that in comparison with the United States, Europe has a mix of fiscal and monetary policies that relies too heavily on the latter. And the development of the European financial structure has lagged behind that in the United States and behind the economic structure in Europe. The result has been a high level of interest rates, a wide spread between short and long rates, and a persistent tendency for financing, both long- and short-term, to come from abroad, and especially from the United States.

This view of our balance of payments problem--which attributes the tendency toward excessive capital outflow to special attractions for U.S. corporations to invest abroad and to differences in financial structure and policy mix as between the United States and Europe--does not call for the classical medicine of monetary restriction. What then is the proper stance of monetary policy in these conditions?

I assume and expect that monetary policy will continue to pursue effectively the domestic goals of vigorous economic expansion and price stability. I also recognize that the motivation to preserve reasonable price stability, though always present, is strengthened by balance of payments considerations.

We can also imagine a gradual reduction over time in the structural disparities making for excess capital outflow. Profit rates in Europe are coming down and this could, over time, reduce the pull on corporate investment. A more efficient European financial structure is likely to develop. Fiscal policy may become more attuned to stabilization needs and more flexible. And, at times, Europe might experience more slack while the United States economy is buoyant.

But none of these developments can be counted on either to reduce in the near future or to repress permanently the tendency for U.S. funds to flow to Europe in amounts greater than are re-absorbed by our current account surplus.

This then is the challenge: how to deal with this tendency in a way that meets our international obligations but does not surrender our monetary sovereignty--that is, our freedom to use monetary policy for the purpose of encouraging a vigorously-growing and inflation-free economy.

I do not wish to be misunderstood. I am not suggesting airtight compartmentalization of the U.S. monetary system from the rest of the world. I am not suggesting that monetary policy ignore the balance of payments. What I am saying is that monetary policy cannot ignore the domestic economy.

In searching for ways to reconcile these goals--balance of payments equilibrium and a healthy domestic economy--our Government has adopted the interest equalization tax and the voluntary restraint programs for bank loans and corporate investment abroad. Without pursuing the technical aspects of the matter, I would suggest that the longer run reconciliation we seek must continue to involve selective measures of the type exemplified by the interest equalization tax.

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I turn now to a quite different but related problem. I think it has become generally evident that extending the period of sustained economic growth and prosperity of the sixties is a growing challenge to our understanding of the economy and to confidence in our ability and willingness to use that knowledge well. The optimists read the economy's recent performance as a demonstration that, given appropriate private and public policies, we can look forward to achieving sustained aggregate growth without significant interruption. To them it appears that if the causes of business recessions are not being eliminated by vastly improved knowledge of markets, and forehandedness in putting this knowledge to use in investment and inventory policies there are public policies, fiscal and monetary, that can be used to offset the disequilibrating effect of private miscalculations without contributing any of their own.

I think there is much to be said for this interpretation of recent economic history. I worry more about an opposite pessimistic view, which grows out of a hunch or feeling that sustained growth and prosperity can't last much beyond previous calendar records. I refer to this view as being based on a "hunch or feeling" because it is seldom, if ever, portrayed in specific analytic terms. It is sometimes described as "I'll hate myself in the morning" school. They may say, for example, there is too much credit, but to them saving is still a virtue and they advocate institutional arrangements to encourage saving with no apparent awareness of the concomitant increases in debt. Others have apprehensions about the present-day use of credit and the terms on which it is extended. But they favor an overall restriction on its proper use as well as on its misuse. Many of these fears and one-sided views come from looking at the trees and not the forest, but that does not mean they should be brushed aside. Even when policy objectives are being met in the aggregate, policymakers must remain alert to shifts in the composition of activity which may be creating imbalances that threaten continued progress.

In the credit area, are there some aspects of contemporary developments which, from either the overall or the structural view, are a cause for concern? One cannot be sure. We know there are hosts of imaginary ghosts and there may be some that are real. My choice of a ghost, which could turn out to be a flesh-and-blood menace to our credit structure, is not too much debt in the aggregate nor in broad economic sectors; nor is it the level of credit quality which cannot be safely serviced by an expanding economy. It is the business of borrowing short and lending long--the transformation of liquid claims into long-term credits by depository intermediaries. In this country the process, usually designated as intermediation, though far from new to our financial structure has been spreading rapidly.

The high and rising income levels since 1960 have generated correspondingly large savings flows. And an exceptionally high proportion of these flows reached capital market borrowers through intermediaries.

In the four and one-half years since the current business expansion got under way, U.S. individuals as savers have increased their holdings of financial assets at an average rate of $43.5 billion each year. Over the same period other nonfinancial sectors of the economy--principally businesses and State and local government units--have been adding to their holdings an average of about $10 billion per year. Without financial intermediation these unprecedented savings flows probably would not have occurred and U.S. capital markets could not have provided the financing made available to a wide range of highly diverse borrowers.

Most of these borrowers need funds for relatively long periods. In the years since 1960, net mortgage financing has averaged about $26 billion annually; corporate and foreign bonds over $6 billion, and municipal bonds only a little less. At the same time, the Treasury has striven to lengthen debt maturities, principally through advance refundings. All of these instruments are long term and most of them are quite illiquid since secondary markets are inactive or non-existent. Such assets do not fit the needs of many household savers who accumulate funds in small amounts and expect to need the money either for some specific future purpose or for a variety of contingencies which might call for cash on short notice. That is, they need either a dependably liquid asset or a contractual assurance that the contingency for which they are saving will be met.

Financial intermediaries of a depository type--commercial banks, savings and loan associations, and mutual savings banks--supply the first of these needs by providing a dependable and prompt conversion into money. Such institutions as insurance companies and pension funds meet several categories of specific contingencies by issuing contracts covering a variety of circumstances. Since 1960, about 86 per cent of all household savings have reached credit markets indirectly through one or the other of these intermediary types.

As I said before, this process of intermediation is far from new though it has been growing strikingly in importance.

Rough estimates of the magnitude and disposition of household savings in the 1920's indicate that nearly half of such savings even then were channeled through depository and contractual intermediaries. And by the mid-fifties, the proportion had risen to 70 per cent.

What has been new and potentially challenging about developments since then is the very rapid growth in savings of a depository type and the compounding influence of a vastly more important role of commercial banks in acting as a channel for these flows. Earlier in the postwar period, insurance companies and the burgeoning pension funds had accounted for the most rapid expansion. In fact, contractual intermediaries came to service more than a third of household savings flows in the mid-fifties--more than double their relative importance in the twenties. Among depository-type savings institutions, savings and loan associations were the most aggressive competitors and then accounted for the largest share of expansion in liquid asset holdings by individuals.

Since 1960, on the other hand, a revitalized commercial banking system has led all other financial intermediaries in competition for savings and rate-sensitive funds by offering liquidity on an unprecedented scale to its time depositors. Sustained economic expansion has given banks an incentive to compete for an increased share of savings flows while upward adjustments in regulatory ceilings on rates they could offer have maintained their ability to do so. Despite bank competition, other savings institutions were able to expand their own inflows over most of the period, though not in recent months.

The practice of paying savings deposits on demand, fully meeting short-term market rates, and (particularly in the case of savings and loan associations) of accruing interest daily on balance have all provided the maximum motive for individuals to place more of their savings in institutions. Depository-type savings since 1960 account for well over half of the record household total, with commercial banks attracting rather more than two-fifths of this enlarged flow.

At the same time, development by the commercial banks of the negotiable certificate of deposit, with its active secondary market, has given them an instrument affording large corporate, Government and institutional customers instant liquidity at fully competitive rates. Competing successfully with short-term market alternatives, negotiable time deposits have reached a magnitude of $16 billion.

For the saver and investor this is the best of all possible worlds. He has a highly competitive return on his funds, and yet they are always available for direct expenditure or direct investment if market conditions open up more exciting earning opportunities. While competition for funds among intermediaries and issuers of short-term instruments has thus raised returns at the short end of the yield curve, the channelling of increased inflows into the hands of institutional buyers of long-term instruments has provided ample funds for financing the unprecedented expansion in credit use by corporations, consumers and the various units of government. Meanwhile, financial institutions have lengthened their portfolios, broadened their range of assets and lived well off an increasingly slender interest rate differential.

In surveying these uniformly pleasing results, however, the question naturally arises whether they have been obtained by risking serious destabilizing repercussions in the future. Certainly while banks and other savings institutions have been expanding the volume of liquid claims in the hands of the public, they have been assembling in their own hands an entirely different time profile of matching assets. Not only are their loans and investments far less liquid than the claims against them as has always been true; they are far less liquid than they were five or ten years ago.

In the case of contractual intermediaries, a portfolio whose liquidity depends almost entirely on staggered or amortizing maturities poses no potential problem since both inflows and future obligations can be predictably matched within rather narrow limits. For depository-type intermediaries, however, this is not true, and the mismatching in time structure of their assets and liabilities has worried many observers since it seems, on its face, to carry serious risks, either through widespread dis-savings or sudden massive shifts in earning expectations among alternative asset holdings. There is little historical evidence, however, to suggest that these risks are as serious in fact as they might appear.

Although much individual saving is undoubtedly temporary in nature, in the aggregate financial assets of savers constitute a reservoir which is not drawn down by individual expenditures because withdrawals by some are matched by inflows from others. The same is largely true, though in lesser degree, of the temporary financial holdings by corporate and governmental units; here, however, tax dates and other factors make simultaneous seasonal fluctuations more likely and cyclical factors tend to influence many corporations in the same direction.

As a practical matter, long experience has shown savings rates by individuals to be closely related to income levels and that savings institutions are far more likely to experience variations in rates of inflow than net outflows so long as economic conditions do not deteriorate. Since the meshing of saving and borrowing needs in our economy seems to require the transformation into long-term credits of savings that are thought of individually as short-term, under what circumstances can this mismatching be a source of serious disequilibrium?

There is the possibility of serious strain on the credit structure or financial intermediaries if, for example, the aggregate level of liquid savings were drawn down suddenly and drastically to fuel a consumer spending binge such as occurred twice in the Korean War. The likely stance of monetary policy at such a time would be to slow the recharging inflows to demand deposits, which would otherwise exercise a timely and proportional neutralizing influence on time deposit outflows, at least at commercial banks.

Dis-saving by households in the aggregate as a result of a severe contraction in incomes might also call for aggressive stabilizing action to shield intermediaries from excessive portfolio losses. But, in this case, it may be noted that any action to offset a depository outflow at intermediaries would pose no conflict for monetary policy since it would, of course, be consistent with the expansive policies dictated at such a time by general economic considerations.

In considering the vulnerability of depository institutions to savings outflows, the potentially disruptive contingency--and the one that is most likely to create a challenge to monetary policy--lies in the possibility of relatively sudden shifts of funds from "time" deposits to direct investment in equity or credit markets. In this respect, negotiable certificates of deposit constitute the most vulnerable segment of the total since they are directly competitive with the full range of money market instruments and are held by corporations and other institutions likely to respond quickly to relatively small shifts in yield differentials. Indeed, the most immediate and direct constraint on monetary policy posed by the new profile of bank liabilities may lie in the need to weigh carefully the impact of specific actions on such differentials.

More broadly, those charged with formulating monetary policy must recognize that the process of transforming liquid savings into long-term instruments does lack some of the automatic checks and balances inherent in a single contract between the original saver and the ultimate borrower. A widespread shift by depositors to other forms of asset holdings--say a move by corporate holders of negotiable CD's into market instruments or by individual savers into common stocks--might force readjustments in bank assets that would have serious repercussions on those credit markets in which banks are active and into which it may be difficult to entice other investors without significantly higher yield incentives.

This would be particularly likely in markets such as those for municipal bonds and mortgages where bank participation has increased sharply in recent years. It might well occur whether the readjustment undertaken by banks losing time deposits was confined to reduced takings of new issues or extended to actual liquidation from existing portfolios.

Moreover, yield movements in such markets could easily be exaggerated by expectational factors unless they are recognized early and the monetary authorities intervene quickly. Under these circumstances, policy decisions on the extent to which the contractive impact of a savings outflow should be offset or permitted to take effect would need to be taken in terms of the need to avoid capital market repercussions that could easily swell to disequilibrating proportions as well as the need to maintain consistency with overall monetary policy.

My remarks have dealt with two important challenges to monetary policy in the 1960's--one which is very much in the public eye and the other which is presently obscured from general view. I would not have you believe that these are the only problems on the monetary agenda. There are several others that are at least as intractable and persistent.

Though money management is a kind of nettle-grasping business it is not, and never has been, an exact science. We in the trade hope for great progress in that direction in the future. In the meantime, the gaps in our knowledge of the linkages between the financial and the real economy must be bridged by liberal reliance on judgment and insight.

The public has a responsibility too. Its role in monetary affairs, though often ignored, is vital because, in the final analysis, the public decides through political processes what kind of a monetary system it will have and who is to be responsible for its operation.

It has often been wisely said, but more often foolishly forgotten, that "money will not manage itself." This responsibility cannot be eluded, evaded, left to "natural forces" or enshrined in mysticism. Since civilized man has made money to serve his interests the public responsibility is to be alert to temptations to undo this creation or in some roundabout way create its undoing.