Statement of George W. Mitchell, Member of the Board of Governors of the Federal Reserve System, before the Joint Economic Committee
December 13, 1965

Consideration of the issues involved in the December 3 actions by the Federal Reserve Board must begin with the state of the economy and its prospects for the future.

The current expansion, which has been going on since early 1961, received a new impulse from the tax cut of 1964. Output accelerated, unemployment declined, and the capacity utilization rate rose; by the summer of 1965, unemployment was down to 4-1/2 per cent and an estimated 91 per cent of manufacturing capacity was in use. Just when there was some danger of a fall-off in the rate of expansion--as the steel wage settlement led to an inventory run-off--the commitment to greater involvement in Vietnam provided a new impulse in the form of stepped-up Federal spending and the expectation that more was in the offing. And we now know that business outlays for plant and equipment have accelerated in recent months and are expected to forge ahead in the first half of 1966. In the past year or so, we have experienced some upward creep in wholesale prices after several years of virtual stability in the index.

These developments pose both a promise and a challenge. The promise is that the economy continues to move steadily toward full use of its labor force. The challenge is to achieve that goal and to maintain it without inflation. It is to be expected that differences of opinion regarding economic policy measures will assert themselves in these circumstances. For my part, at this time the highest priority attaches to a combination of economic policies that will ease the economy onto a steady growth path at full employment. I believe this can be done with reasonably stable prices. I would grant that as we achieve full employment, and are in orbit so to speak, our efforts to expand aggregate demand should inevitably be limited by growth in productivity and the labor force.

What is currently at issue is whether a further shift toward restraint--and a spectacular signal of the sort implied by a discount rate increase--was needed. The difference in view on monetary policy at the moment is based on differences in judgment on three questions regarding the recent and prospective performance of the economy.

1. Does the nature of the price advances we have had during the past year indicate that inflationary pressures are responsible? Food prices have risen significantly--but because of supply conditions in agriculture. Several internationally traded commodities have risen sharply--but because of political uncertainties and strikes in supplier countries and demand conditions outside as well as in the United States.

Among industrial prices, increases have been selective rather than widespread, and more recently have tended to slow. In one-half of 70 industrial groupings, wholesale price changes since August 1964 have been within $\pm$ 1 per cent.

As guides to monetary action, our price indexes--both the Consumer Price Index and the Wholesale Price Index--leave much to be desired. The Consumer Price Index accentuates the illusion of rising prices properly attributable to higher incomes and rising consumption standards. As pointed out in the Stigler Report, it does so by the upward bias inherent in its treatment of quality changes in goods and services. And the public tends to think of its consumption standards as constant and prices as rising whereas a significant part of the "price rise" has purchased improved products and better services.

The Wholesale Price Index has its defects too--mainly that it moves sluggishly and understates the magnitude of price adjustments that are normal in our economy. Interpreting the movements in both these indexes gives rise to many shades of opinion. The price picture has changed in the past year and expectations regarding prices may also have changed. But the evidence on prices does not, in my view, now call for more monetary restraint than is already being applied.

2. The second question underlying the current debate on monetary policy has to do with the rate of unemployment and the potentiality for reducing it further without generating excessive upward pressures on costs and prices. Those who regard 4 per cent unemployment, or 3 million persons, as the approximate total of the frictionally unemployed and the unemployable, and who are especially impressed with the fact that the unemployment rate among married men is down to 2 per cent, may feel that we have achieved our employment goals and that any further progress in reducing over-all unemployment cannot come from aggregate demand. I am not one of those. And I would not choke off growth of aggregate demand if it risked committing a million or more workers, many of them young and the most recent products of our educational system, to the dole or a new category of welfare dependence.

There is no doubt that shortages of skilled labor are being felt at various points in the economy. On the other hand, I remember clearly that many observers a year and more ago were doubtful that unemployment--then about 5 per cent--could be reduced further by expansion of aggregate demand. Yet it has been reduced and unit labor costs have remained relatively stable. On this basis, I am not yet ready to agree that there is no further room for compression of the unemployment rate--with significant benefit to disadvantaged groups. I would also stress, incidentally, that the age distribution of our population is such that there is little increase in numbers among the 30-45 year-olds. To achieve adequate growth in the economy, our labor force must grow, and for this we must absorb the younger entrants into employment.

3. The third question on which I would like to comment concerns the rate of growth of bank credit. Many observers look at the numbers--showing that bank credit has expanded by about 10 per cent this year, while GNP has been increasing at a rate of about 7 per cent--and conclude that the economy is being oversupplied with bank credit. This is a matter for analysis and judgment. In arriving at judgments on this question, one must keep in mind that bank credit statistics have become very difficult to interpret because of the significant expansion in the role of commercial banks as financial intermediaries. Commercial banks, by offering negotiable certificates of deposit and other new savings instruments, have in recent years captured a larger share of the flow of funds on their way from savers to borrowers. This enlargement in the banking system's share of the savings flow necessarily brings with it a much more rapid growth of bank assets than would flow from a 4 per cent increase in demand deposits.

The question whether credit expansion is excessive because of monetary creation has no easy answer. It is significant, however, that the rate of growth of bank credit has declined in the course of this year, from an annual rate of over 12 per cent in the first quarter to less than 5 per cent in the third quarter.

Now the fact is that the posture of monetary policy has changed in the past year, especially in the second half of 1965. In the recent preoccupation with the discount rate little attention has been given the shift in monetary policy toward greater restraint brought about by open market operations. That monetary policy has become more restrictive over a period of months is evidenced in the advance in interest rates on public and private securities of all maturities since the spring of this year. Long before the discount rate action, Treasury bill yields had risen--from 3.8 per cent in the early summer to 4.1 per cent at the end of November; long-term Government bond yields had risen--from 4.14 per cent in June to 4.34 per cent in late November; the yield on new issues of high-grade corporate bonds had risen--from 4-1/2 per cent in the spring to about 4-3/4 per cent in late November; and mortgage yields had also begun to move up.

Recent public discussion of Federal Reserve actions has largely ignored the fact that open market operations--not discount rate policy--are the principal instrument of Federal Reserve policy. The major task of the Federal Reserve is to regulate the volume of bank reserves, which affects the rate of expansion of bank credit and money, and thereby influences interest rates and other credit conditions. The discount rate has important psychological and announcement effects, but the real muscle in monetary policy will be found in the open market actions that follow. Thus the impact of monetary policy on the economy in the weeks and months ahead will depend more on the open market policy to be followed than on last week's discount rate action. And open market policy should, in turn, depend on the strength of the private economy and on the impact of fiscal policy.

The recent increase in the discount rate has been interpreted by the public as a decisive shift toward more restrictive monetary policy. And it may prove to be so. A higher discount rate can influence future open market policy toward greater restrictiveness, insofar as the policymakers come to regard the new discount rate as the level toward which Treasury bills and other money rates should gravitate. This is one of the reasons I opposed the discount rate increase last week.

It seems to me that such an action, given its announcement and psychological effects, should have awaited, and been coordinated with, other Government decisions to be taken over the next several weeks and to be announced in the Budget and the Economic Report. Such consultation and coordination, in my view, would not in any way have been inconsistent with the independence of the Federal Reserve.

The issue of independence of the Federal Reserve calls for a brief comment. In my view, independence of judgment is much more than a matter of legal right, for laws can be changed. Real independence, the only enduring kind, rests on wise and responsible behavior. The measure of independence that the System has retained over the years reflects its sparing use of dissent and the care and skill with which the System's views have been negotiated in controversial analyses and judgments. I might add that a similar sort of independence is found within the Federal Reserve where individual policymakers prize and use, as I did last December 3, the right to dissent.

Turning now to a matter on which I did not dissent, the increase in maximum rates payable on time deposits was justified, in my view, whether or not the discount rate was advanced. This move must be viewed against the background of the past several years in which we have witnessed what could be called a "revolution" on the liability side of bank balance sheets. Banks have been transformed from relatively passive acceptors of deposits to competitively active seekers of deposits. While this situation must be under constant surveillance so as to guard against imprudent lending, more active competition from banks should be a benefit to the economy.

In the current circumstances, rates on negotiable certificates of deposit were pressing the ceiling. It seemed desirable to remove this impediment to competition among banks and to the free flow of funds. This does not mean that I sought or expected a substantial upward adjustment of short-term interest rates in response to the raising of the ceiling. It does mean that I saw the need for more leeway for banks and for them to know that they could offer higher yields, if necessary, as they sought funds.

On past occasions when Regulation Q ceilings were raised--actions in which I also concurred--banks put their enlarged flows of deposits to work in purchasing mortgages and State and local government securities, with downward adjustment in the interest rates on these obligations. There is little scope for such downward interest rate movement now, but there was a danger, before the ceiling was raised, of a sharp rise in rates if the inability of banks to continue to attract time deposits forced them to limit further their acquisitions of municipal securities and cut back on mortgage lending.

The month of December usually witnesses an exceptional concentration of money market pressures. I do not claim that a rise in Regulation Q ceilings was essential to see the money market through this period. Rather, the provision of reserves by the System could have accomplished this task, by offsetting tendencies for money market yields to rise and making it possible for banks to sell certificates of deposit within the existing ceiling to replace CD's maturing this month. But the continuation of such a policy into next year might well have required too rapid an increase in bank reserves and consequently too rapid a rate of monetary and credit expansion, given the strength of aggregate demand.

In brief summary, my position on the posture of monetary policy in the current changing circumstances is that the discount rate action could have been delayed, to await coordination with other Government policies. My willingness to delay discount rate action in this way is based on the fact that monetary policy has already tightened, on the lack of evidence that inflationary pressures are strong or accumulating, and on the belief that we should continue to set high standards for the performance of the economy and, especially, for the reduction of unemployment.