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Statement by

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I am happy to appear on behalf of the Board of Governors of the Federal Reserve System to discuss the implications of U. S. Treasury financing requirements for monetary policy. Your Chairman has asked me to comment, in particular, on whether the increased Federal deficit financing needs soon to be created by the Administration's proposed fiscal package are likely to complicate the management of monetary policy.

At the outset, I should emphasize that under the institutional arrangements in the United States, decisions on monetary policy and Treasury debt management are kept relatively independent from one another. When the Treasury seeks to issue new debt, it generally does so in the securities market, paying rates that are competitive with those available on debt securities of other borrowers. This market-oriented approach permits the Treasury to cover its financing requirements without special support from the central bank. The Federal Reserve is then left free to pursue its monetary policy objectives, which are set with reference to what we believe consistent with the emerging needs of the overall economy.

In some other countries, new public debt is financed initially at the central bank, often at rates below the cost of borrowing from market sources. When this approach is followed, the central bank in effect creates money to pay the government's bills, at least until such time as it can successfully resell the securities to the private investment community. Monetary policy is thus subordinated to the immediate requirements of financing the public debt, and in the process the central bank may sometimes lose control of the nation's supplies of money and credit. Sooner or later, this lack of control is likely to bring escalating rates of domestic inflation, along with the economic distortions and instabilities that rapid inflation breeds.

The fact that our governmental structural separates responsibility for debt management from that for monetary policy, however, does not mean that the Federal Reserve is not vitally interested in successful Treasury debt management. A failure by the Treasury to cover its financing requirements, in addition to precipitating a crisis in public credit, would disrupt financial markets and create serious problems for other borrowers as well. Such a development would doubtless make it necessary for the Federal Reserve to divert open market operations for a time from more fundamental objectives to the task of coping with the immediate financial market difficulty.

To help minimize the possibility of Treasury financing failures, the Federal Reserve during the 1950's and 1960's followed the practice of maintaining an "even-keel" posture in monetary policy at the time of major debt management operations. Basically, this commitment meant that during the critical days of important Treasury financings in the coupon market, the Federal Reserve would not take overt monetary actions--such as a change in the Federal Reserve discount rate or a significant shift in the thrust of open market operations--which might be construed by participants in the U. S. Government securities market as a basic adjustment in monetary policy. In more recent years there has been a gradual relaxation in the constraints on monetary actions imposed by this "even-keel" commitment. This relaxation has been possible mainly because the Treasury has introduced debt management innovations that have made its financings less vulnerable to sudden variations in market interest rates.

Perhaps the most significant of these innovations has been the increased emphasis on the auctioning of new debt offerings. In the 1950's and 1960's, when the Treasury sold new notes and bonds it generally announced fixed interest rates on the new issues 5 or 6 days in advance of taking subscriptions. Under this procedure the financing could be jeopardized by any sizable, unexpected increase in market interest rates that developed between the announcement and actual offering of the new issues. When yields on outstanding market securities rose just before the offering date, the terms of the new issues naturally looked less attractive to investors. If this erosion of investor interest went too far, the Treasury ran the risk of failing to sell enough of its new debt and thus of being temporarily embarrassed for lack of funds. Under the auction procedure now used this risk is reduced, because the yields and prices of new issues are determined through bidding on the date of the financing itself, rather than some days before.

A second innovation in debt management that has diminished the constraint of "even-keel" considerations on the conduct of monetary policy has been the restructuring of much of the marketable debt into regularized cycles of debt offerings that can be handled on a rather routine basis. Financings are split into moderate-sized auctions that occur on a definite schedule, which encourages investors to accumulate funds for regular placement in Treasury issues.

It is fortunate that the Treasury has been able to channel much of its recent borrowing into these relatively routine debt offering cycles, because the heavy Federal deficits of the past few years have greatly expanded both the aggregate volume of Government financing and the frequency of new issues. Last year, for example, the Treasury sold in the market $93 billion in new notes and bonds to refund maturing debt and to raise new cash, far above the $25 billion average annual volume that had prevailed during the decade from 1965 to 1974. Moreover, last year's financings included 30 separate issues of new marketable debt other than Treasury bills, compared with an average of 12 per year from 1965 to 1974.

Against this background, if a rigorous "even-keel" approach to Treasury financings were required, the greater frequency of operations could often delay needed Federal Reserve actions, and to that extent reduce the flexibility of monetary policy. Of course, there is always a free and full exchange of information on such matters as financial market conditions and Federal financing requirements between the Treasury and the Federal Reserve. But if we are to be successful in maintaining effective control over longer-run growth in the monetary aggregates, sufficient leeway to make timely adjustments in the supply of bank reserves is an essential prerequisite.

This brings me to the more immediate question of whether the Administration's proposed tax rebate and social security payment package is likely to create any special difficulties for Federal Reserve policy during the months just ahead. Two possible sources of difficulty have been identified.

First, some analysts have speculated that the sheer weight on financial markets of Treasury borrowing to finance this package might inhibit the flexibility of Federal Reserve actions. I do not think that this is a realistic possibility. Although the $10 billion or so expected to be distributed as tax rebates and associated payments during the next few months is a very large sum, it is not likely to create a major financing problem for the Treasury. Not only will the bulk of the payments be occurring during a part of the year when regular income tax receipts would otherwise be creating a seasonal surplus, but the persistent shortfall in Federal spending below budget estimates thus far in the current fiscal year has held aggregate deficit financing requirements somewhat below market expectations.

In a broader sense, the addition of another $10 billion to the Treasury's borrowing needs extends the period of exceptionally heavy deficit financing and increases the risk that adverse financial market effects could begin to accumulate. The Federal deficit in the current calendar year--including the deficits of off-budget agencies--now seems likely to approach $80 billion, up $17 billion from last year and only moderately less than in calendar 1975. If these large deficit financing needs persist into the time when private credit demands are rising strongly in response to continued economic recovery, substantial pressures on both the cost and availability of credit might very well develop. But this is a longer-run and more generalized concern.

The second aspect of the fiscal package that poses a potential problem for the Federal Reserve is the likelihood that the rebates will produce temporary--but difficult to interpret--distortions in the monetary aggregates. To the extent these temporary rebate effects disguise the more fundamental influences on monetary growth, it will be difficult for a time to determine the near-term course in money growth and interest rates that is most likely to be consistent with the developing financial requirements of the economy.

To help understand why the impact of the tax rebates on monetary growth is so difficult to predict, let me briefly discuss the relationship of U. S. Treasury cash balances to the money supply. First, it should be noted that although the Treasury holds its cash balances as demand deposits, partly with commercial banks and partly with Federal Reserve Banks, neither type of deposit is included in statistics on the money supply. Deposits held by other key types of spending units--households, businesses, and State and local governments--do, of course, all appear in the monetary aggregates.

The rationale for excluding Treasury deposits from the various measures of money has traditionally been that spending decisions by the Federal government are not at all influenced by the size of its cash position. Federal spending programs are legislated by Congress and supported by tax revenues or borrowed funds. Thus, the level of the Treasury's bank balance at any given point simply reflects different flow patterns of outlays and receipts.

The spending decisions of other economic units, on the other hand, do appear to be influenced significantly by the size of their liquid balances. Since this relationship is a critical link in understanding the probable impact of monetary developments on aggregate spending in the economy, it is important to have statistics on the monetary aggregates that provide the most meaningful analytic measures of these variables.

The exclusion of Treasury balances from the published money supply statistics, however, may occasionally present difficulties in interpreting short-run movements in these data. Whenever taxpayers or investors make net payments to the Federal government, their deposit balances tend to be drawn down and those of the Treasury rise. Similarly, when the Treasury spends more than it receives, its balances are drawn down and those of other units in the economy tend to rise. But most of these shifts in cash position between the public and the Treasury are regularly recurring events related, for example, to the timing of tax payment dates and periodic Treasury financings. Therefore, they tend to wash out in the seasonally adjusted measures of the money supply that are used as guides to monetary policy.

Even after taking out the seasonal, our statistical studies have not shown a predictable, consistent relationship between variations in the Treasury's balance and changes in money growth rates. This is probably because of the myriad of transactions that go through deposit accounts each day, and also because most large depositors typically adjust their demand balances promptly to desired levels. In the rebate case, however, the Treasury disbursements will be especially large; they will be concentrated in timing and non-seasonal in character; and the payments will be made to families rather than to business units. There will probably be some delay as families deliberate on how to use the windfall and, if so, there will be a sharp temporary upsurge in their average cash balances and a resulting spurt in the growth of the monetary aggregates. Later, as these balances are spent, there should be a reversal of the money bulge, and a concomitant slowing in monetary growth until the recipients have used the funds and cash balances have been reduced to normal working levels. This is the pattern of response that seemed to occur in the money growth numbers during the prior tax rebate episode in 1975.

Looking to the months ahead, it is hard to judge with any precision how large the distortions in money growth rates triggered by the 1977 fiscal package may be. We have only one prior experience to draw upon, and today's economic setting differs in important respects from that of two years ago. Hence, the Federal Reserve is likely to have considerable difficulty as the period progresses in assessing the more fundamental developments in the underlying trend of money growth.

Most analysts clearly recognize the complications in evaluating money growth rates during and immediately after the forthcoming rebate period. But the intriguing point to me is that different experts commenting on how the Federal Reserve should cope with this problem are offering us diametrically opposing advice.

Some argue that because the data on the monetary aggregates can be expected to behave erratically, the Federal Reserve should disregard them in the period during and immediately after the rebate period. Instead they recommend that we focus on keeping money market conditions--including the Federal funds rate--from tightening. Since the economy is operating at substantially below its optimum rate, they see little risk in adopting this policy approach.

Others argue, on the other hand, that even temporary abandonment of the aggregates as a guide to policy would be risky, given the long lags with which monetary conditions affect the economy. If the expansion is now gaining momentum, which seems probable, resorting to a stable interest rate policy might lead to a substantial overrun in growth of the aggregates--going well beyond the temporary rebate influence. If this were to happen, it is feared that the Federal Reserve would experience difficulty holding the longer-run growth rates of the aggregates within the ranges that have been specified, with probable adverse future consequences for the rate of inflation. To avoid the threat of excessive longer-run monetary growth, this group recommends keeping a close control over the aggregates, even during the rebate period.

It seems clear that any rigorous effort to hold down monetary growth rates during the rebate period would bring substantial and potentially unsettling short-run interest rate movements--first upward, and then downward--as the adjustments in money balances are made. Such fluctuations would seem to serve little purpose and could be misleading and disadvantageous to both borrowers and lenders. A total lack of attention to the aggregates, on the other hand, could permit a sizable lasting expansion in money and credit to get under way, particularly if the economy continues to strengthen generally over the period ahead.

In my view, there is a safer middle course between these two recommended policy approaches. This course would be to attempt to estimate, in advance, the deviations from otherwise expected patterns of money growth that might develop due to the special Treasury payments. These estimates would allow both for an initial period of temporary acceleration in monetary growth and a succeeding period of temporary slowing. A need for possible Federal Reserve actions to counter unusual developments in the monetary aggregates would then be indicated only to the extent that actual growth rates moved well beyond the parameters established by these allowances.

While this was the general approach followed by the Federal Reserve during the tax rebate period of 1975, only a single point projection of the rebate effect was formulated and there was no prior experience on which to base the estimate. As it turned out, that point estimate was on the low side. Consequently, policymakers inferred that the monetary expansion actually observed in the spring of 1975 was greater than could be attributed to the rebate and hence greater than would be subsequently reversed. Looking back to that experience, both the rebate influence and the reversal appear to have been underestimated.

This time around, I would expect greater recognition to be given to the uncertainties surrounding estimates of what proportions of the rebates and other distributions will be retained in money form, and for how long. It may well be that a range of projections will prove more reliable than a single point estimate in order to bracket the various possibilities. Thus it is probable, as Chairman Burns stated at a Senate Budget Committee hearing last week, that our zone of tolerance in permitting monetary expansion to run at high rates for a while will be somewhat wider this time. But if we find that monetary growth does not subsequently moderate in the expected degree, we may then need to act to keep longer-run expansion of the monetary aggregates within our stated ranges.

While it is clear that observed money growth rates are likely to show sizable fluctuations in the period to come, Federal Reserve policy will continue to seek longer-run growth rates appropriate to the requirements of the economy. At the same time, it is undesirable and unnecessary to expose the economy to the uncertainties and destabilizing effects of movements in interest rates if these are likely to be reversed shortly. Careful monitoring of emerging economic and financial developments during and after the rebate period should permit us to allow for any needed adjustments in money growth rates and interest rates on a reasonably timely basis. This is so since a major virtue of monetary policy as an instrument of demand management is its operational flexibility.

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