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Inflation and Financial Stability

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Inflation and Financial Stability

Last January when I was in London I picked up the paper one morning and read the following weather forecast: "Sunny intervals. Rain, hail, sleet, snow. Cloudy." Parenthetically, I might mention that this particular forecast turned out to be correct--except for the hail! But my point is not the relative prescience of economic or weather forecasters; this is not a point in time when such a comparison would necessarily flatter the economist. Rather the point of my story is that today here in Georgetown we happily seem to be in one of those "sunny intervals" both with respect to the domestic and international scenes, although many, if not most, observers foresee clouds ahead on both horizons. On the domestic side, the cloud on which many economic weathermen seem to be concentrating is that of an undue slowdown in business activity, perhaps sometime early next year. The theme of my remarks here today, however, is that long before we get to that cloud, we are still in the shadow of an overlong continuance of inflationary pressures and inflationary expectations which severely complicate the problem of achieving financial stability and sustainable economic growth.

Roughly three months have elapsed since the President signed into law the long-awaited bill imposing fiscal restraint on the U. S. economy. I suppose no one was fully satisfied that the new measure gave us the optimal degree of fiscal restraint, or the ideal division of restraint between higher taxes and expenditure reductions. But after a full year of active political controversy on a fiscal action that should--in my view--have been taken at least 2 1/2 years earlier when some of us in the Federal

Reserve System began to call for it publicly, almost any mixture or degree of fiscal restriction would have seemed better than none to anyone seriously concerned with the stability of our domestic economy, our financial markets, and the international financial mechanism.

In the weeks that have elapsed since its passage, this fiscal action has come to be billed by the press as one that will provide the acid test of the relative importance of fiscal and monetary policy as determinants of economic activity. There is, it seems to me, some doubt as to just how conclusive the developments of the next several quarters will be. A more definitive test would have resulted from a fiscal measure assuring that appropriate changes in tax rates and Government spending could be maintained over a period of longer duration than a single fiscal year, or from a fiscal measure imposed early enough, or in sufficient size, to check in their infancy the inflationary pressures and expectations that are now entrenched. Since many observers assign a probability significantly above zero that fiscal restraint will not extend beyond mid-1969 (although for my part I am not prejudging this), and since inflationary pressures and expectations are still very much with us, both consumers and businesses have been encouraged to sustain their purchases above the levels they would otherwise have maintained.

Let me make my own position on the central issue clear, however. Even though the effects of this fiscal restraint measure will be moderated by its potentially temporary nature, and delayed by strong inflationary pressures and expectations that are not readily reversible, I do think the

measures taken represent a substantial and effective dose of fiscal medicine. Between now and the middle of 1969 I would hope and expect to see a significant slowdown in the pace of GNP from the excessive rates of growth we experienced in the first half of this year, and to a lesser degree apparently also experienced in the third quarter. Thus, I do not agree with those who have prematurely jumped to label this the "lost" economic slowdown.

It is, to be sure, becoming increasingly clear that the effects of fiscal restraint are not showing up as quickly as some observers had expected. GNP growth this quarter could prove to be as large as \$15 billion, and if that size increase would not be especially surprising, its indicated composition surely is. Such an increase in GNP this quarter would reflect a stronger performance of final sales, and less inventory accumulation, than that which most observers had been expecting. Consumer purchases particularly--following a jump, perhaps exaggerated, in retail sales in July--seem to have remained on a high plateau during August and September.

Perhaps this summer's developments reflect no more than our usual inability to forecast consumers' changing short-run propensities to spend--quarterly movements in the personal savings rate have been exceptionally erratic over the past several years. My own feeling is, nonetheless, that the continued economic strength we have seen this summer represents more than just happenstance, or a longer-than-usual lag in the adjustment of private spending to the tax increase. We are, as I see the matter, simply

witnessing developments that clearly reflect the failure to adopt adequate measures of fiscal restraint much earlier.

The developments of these past three years have built into the calculations of consumers and businesses a set of expectations about price and wage trends that are helping to sustain spending--and likely will continue to do so for some time. This same set of expectations thus makes more difficult the achievement of financial stability. It must be obvious to any reasonably close observer of economic developments in the U. S. that today's labor contracts have a strong influence on wage rates and costs for several years in the future. At least some of these pressures on costs are likely to leak over into the price structure. We should thus not be unduly surprised that the private sector has been rather slow in responding to the tax increase. Given the inflationary expectations now built into the system, perhaps we should consider ourselves fortunate that at least a significant reduction in the growth rate of aggregate spending does seem to have occurred in the third quarter--even though it was not due mainly to fiscal restraint.

While the delay in getting fiscal restraint has been costly in terms of the speed or facility with which we can expect to moderate the pace of domestic inflation, it has been much more so with respect to our balance of payments position. Three years ago there was reason to hope that our over-all balance of payments was moving in the direction of equilibrium, and our merchandise trade surplus at that time--though diminishing--was huge by comparison with the annual rate of the first half of this year.

Excessively rapid expansion in total spending during the past three years has seriously eroded our trade account, and it will take considerable time to regain the magnitude of trade surplus we need to maintain a viable equilibrium in our overall payments accounts without controls on capital flows.

Let me say, however, that the situation we face is far from a despairing one. I do think there is reason to expect real improvement in our trade balance in the latter half of this year, and still more in the first half of 1969, when the fiscal restraint measures taken several months ago should be exercising more visible effects on private spending than they have up until now.

There is room for optimism on this score, it seems to me, because the deterioration in our trade balance was less the product of relative price trends here and abroad than it was the result of the impact on our imports of rapid growth in money income at home, together with accompanying pressures on domestic supplies of goods and resources. The response of our trade balance to a slowing in the pace of expanding demand should thus be quite prompt, and hopefully substantial.

Developments in our domestic financial markets since spring have been almost as puzzling as those in the real sectors of the economy. Growth in the money stock was exceptionally large for a time. Interest rate reductions, on the other hand, have seemed relatively modest, given the marked intervening increase in the growth rate of commercial bank deposits and credit. In fact, interest rates on a variety of financial instruments reached their lows in late July or early August and have risen modestly since then.

It seems clear that the inflationary expectations helping to sustain the high growth rate of private final sales also have been partly responsible for the reluctance of nonbank investors to take positions more readily in fixed-income securities. With credit demands of private borrowers remaining relatively strong, (bank loans to businesses are something of an exception), and the Treasury and state and local governments raising large amounts of cash, such investors pursued cautious investment policies, awaiting more clear-cut evidence that fiscal restraint was slowing down aggregate demand. And monetary policy has also moved cautiously, including a small technical adjustment in the discount rate, rather than an abrupt change or all-out effort to bring interest rates down further.

Factors such as these go some distance toward explaining the behavior of interest rates this summer, but they leave quite unexplained why the private sector was willing to add such large amounts to its holdings of money balances earlier this past summer. Growth in the money stock was large in May and continued to be rapid in June and July, giving rise to widespread doubts that the measures of fiscal restraint we have adopted would be effective in cooling off the economy.

While such concerns are understandable, they sometimes emerge from too mechanical an application of a simple theory of the relation between money and money income. One cannot safely argue, it seems to me, that any increase in the money stock above some long-run norm necessarily represents additions to money balances in excess of those desired by the public and hence is bound to be inflationary. In the short-run, increases in actual money holdings relative to those desired by the public at existing

levels of income tend to drive down interest rates--as the public tries to part with money to acquire other financial assets in restructuring its asset portfolio. This is one of the important ways through which an increase in the money stock feeds through the financial markets to generate increased demands for goods and services--and ultimately leads to an increase in nominal income. But interest rate developments have not suggested any exceptional increase in money stocks relative to the public's desired holdings. On the contrary, as I noted earlier, the interest rate reaction since spring has been surprisingly mild. That is to say, while the money supply is clearly important, so also is money demand.

This line of thought leads one, I think, to search for special factors that may have influenced the public's demand for money over the spring and summer months. In particular, it raises a question as to whether patterns of money use during this period do not suggest that there have been some shifts in the demand for money that monetary policy quite properly accommodated.

Questions of this kind are always difficult to answer, given the available evidence, but the data for the period from March through July do, I think, suggest strongly that money demand was increased during this period by unusual developments in financial markets. Through the spring and early summer, demand deposits were swollen by heavy net outpayments from Government balances to private deposits and a large-scale pile-up of credits and idle balances in connection with the great volume of stock market transactions and the sharp rise in delayed deliveries.

On this latter point, for example, while GNP during the second quarter rose at about a 10 per cent annual rate, debits to demand deposits at New York City banks rose at a 50 per cent annual rate, and at nearly a 40 per cent annual rate at six other financial centers. By contrast, debits at New York had risen 11 per cent from December 1966 to December 1967, and the rise was 8 per cent over the same period at the six other financial centers.

The months from March through July thus witnessed an incredibly rapid growth in what must have been essentially financial transactions. Daily sales volume on the major stock exchanges, you will remember, rose to exceptional levels, and delivery delays on securities lengthened to the point where Wednesday closings had to be introduced. The public's demand for money was probably raised substantially by the sheer weight of financial transactions. But it may have been increased additionally by the delay in security deliveries, in view of the greater uncertainty as to delivery and payment dates, and certain institutional practices regarding retention or earmarking of money balances to cover payments for securities subject to delayed delivery.

Let me say a few words, also, about the abrupt change in the growth rate of commercial bank time deposits that has occurred since midyear. In the second quarter of this year, time deposit growth had fallen to about a 3 per cent annual rate. The third quarter rate, on the other hand, apparently was in the neighborhood of 17 per cent, with most of the turnabout reflecting the changed competitive position of CD's.

I would not propose to argue that bank credit growth cannot have an expansionary effect on the economy when its counterpart on the liability side



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of bank balance sheets takes the form of increased time deposits. On the contrary, variations in the growth rate of time deposits have become one of the important ways in which monetary policy transmits its effects through the banking system. But here, too, an excessively mechanical interpretation can be quite misleading. No one would get unduly excited, I presume, if banks sold CD's to corporate customers who otherwise would have held Treasury bills, and then invested the proceeds in the bill market. There is nothing inherently expansionary in the fact that banks, not corporations, buy bills. Such switches in financial asset portfolios would become worrisome if they resulted in undesirably large declines in Treasury bill rates and in rates on other classes of debt obligations, or if banks were induced by the improvement in their liquidity to change markedly their lending terms to businesses or other customers. This does not appear to have been a problem since midyear. The sharp acceleration in the growth rate of CD's induced by the decline in yields on competing money-market instruments reflects little more than the elasticities of demand and supply in the CD market.

We cannot, of course, be sure what part of the large increase in the public's money holdings from March through July might be attributed to these factors. It is clearly not possible, therefore, to be unconcerned with that period of rapid growth in the money stock, and I am not trying to explain it all away as a technical aberration or a shift in money demand accommodated by growth in the stock of money. But I am pointing out that money demand can be partly a by-product of changes in institutional patterns of money uses--which the Federal Reserve must always take into account, and which

illustrates that no single set target for money supply increases is desirable. And it also underscores that there is no reason for hasty conclusions that hopes for cooling off the economy are all but lost.

Admittedly, our concern for what is signified by particular monetary movements should grow more intense with the duration of any period of rapid and sustained growth in money holdings--and in this respect, the figures for recent weeks have been encouraging. The money stock slowed to about a 5 1/2 per cent annual rate of growth in August, and the money stock apparently is declining in September by roughly the amount of the August increase. This would imply a rise during the third quarter of just a little over 4 per cent, at annual rates. And on a weekly average basis the money supply in late September actually was lower than at midyear. In any case, this may be the sign we have been waiting for that the earlier period of rapid increase in the public's holdings of money is finally behind us.

For my own part, at least, I remain reasonably optimistic that we have made, and are making, progress in getting inflationary developments under control. In practice as well as principle, fiscal policy does have an important bearing on the pace of economic activity, and I think it will have in the current test case--even though its effects will be moderated both by the potentially temporary nature of the fiscal measures and by the inflationary setting in which they at long last were instituted. And I do not think, for the reasons I have already mentioned, that the course of monetary policy during this past summer can, by any means, be fairly construed to have obstructed the curbing of excessive economic expansion and the accompanying inflationary pressures. Like others, I still expect the major thrust of fiscal restraint -- retroactive tax payments, budget restrictions, etc.--to take hold.

Nonetheless, overoptimism on our progress toward more balanced growth should be avoided. The effects on private spending that are expected to emerge from the tax increase are, at this juncture, still an expectation. The international uncertainties related to Czechoslovakia and the Middle East, alongside Vietnam, furnish little comfort to those looking toward a leveling of Federal spending as a major factor in moderation of aggregate demand. And we will still be suffering for quite some time from the effects on wage rates, costs, prices, and expectations borne of three years of excessively rapid expansion in our domestic economy.

Our domestic inflationary problem, and its consequence for the balance of payments, is so serious that we cannot afford to dismiss out of hand, in considering the proper course of stabilization policy, the possibility that the restrictive impact of the fiscal measures taken this year may have been overestimated. There is no room now for doctrinaire views that fiscal policy is all-important as a determinant of economic activity. But there is also no room for doctrinaire views that the course of the economy over the next year or so is already predetermined by the past growth of the money stock. And, finally, there is no room for complacency as to the outlook; while the present sunny interval is not immediately shadowed by the cloud of "overkill", or even of "overcool", the cloud of inflation is still a clear and present danger to the achievement of financial stability, sustainable growth, and reasonable equilibrium in our balance of payments.