BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date July 25, 1966

To Chairman Martin

Subject:

From J. H. Furth

Attached a preliminary draft for a speech on Limits of Monetary Policy. It is the revised version of a pre-preliminary draft that has been (rather hastily) scrutinized (and mercifully cut by 40 per cent) by Ralph Young and Bob Solomon. Nobody else has seen it.

If you think that the draft roughly reflects your ideas on the subject and that its line of reasoning sounds convincing, I shall submit the draft, as usual, for comments and suggestions to Charlie Molony, Bob Cardon, Bob Holland, Al Koch, and Art Hersey (both Ralph Young and Bob Solomon will be away this week). I shall also have all factual statements and especially all figures carefully checked and brought up to date.

Unless you advise me to the contrary, I shall assume that you will inform the Treasury or any other Government agency only when the draft reaches a more advanced stage.

Unfortunately, the questions of price and cost developments, vital as they are, may well (at least for the moment) be eclipsed by even more vital and more difficult problems of international finance--unless the disruptive trends of the last few weeks are stopped. The apparent lack of U.S. leadership in this field, compounded by the weakness of the British Government and the dogmatic prejudices and rigidities of the Continental European authorities, has caused anguish even to those of us who so far have managed to retain their optimism and their faith in the good sense of the international financial community.

We all hope and wish for your speediest recovery--and not for personal reasons alone.

JHF

DRAFT:JHF:dch
July 22, 1966

Limits of Monetary Policy

The past nine months have, for the first time since the start of the present upswing 5-1/2 years ago, seen the emergence of serious inflationary pressures in our economy. Wholesale and consumer prices have been rising at annual rates of about 3 per cent; labor costs in manufacturing have begun to inch up; and our foreign trade surplus--our brightest hope in our struggle to end our persistent large payments deficit--has seriously declined.

These developments, while disappointing, have been neither surprising nor inexplicable. On the contrary, they are the normal concomitants of the stage of the business cycle our economy has reached.

Until about nine months ago, we had been able to meet the requirements of a rapidly expanding economy by drawing on unemployed manpower and under-utilized plant capacity. Bringing these idle resources into the production process made it possible to follow stimulative monetary and fiscal policies without bringing forth serious scarcities or bottlenecks of productive factors, which would have strained the maintenance of reasonable price and cost stability and would have impeded progress toward correction of our payments deficit.

All this changed when our economy, in the last quarter of 1965, reached what may be considered a reasonably full utilization of its resources. From then on, further expansion in the aggregate demand for goods and services in excess of the rate of additions to labor force and plant capacity or of a rise in productivity would either be satisfied by means of an increase in imports or a diversion of exports to domestic consumption; or it would be frustrated and result only in rising prices. Clearly, the previous rate of expansion of demand could not be expected to remain sustainable under these changed conditions. Thus, an annual rate of increase of about 6 per cent in the "real" gross national product would have to be reduced to, say, 4 or 5 per cent, in any event; if our GNP as measured in current dollars were to rise faster, it would only lead to serious price and cost pressures and adverse effects on our international payments position.

In order to achieve the transition to a less rapid increase in our national product without risking dislocations that might result in recession or stagnation, it would be necessary for investors and consumers--including, to the extent consistent with national interests, the public authorities--to change their plans. And in order to induce consumers and businesses to do so, it would be necessary to slow down the rate at which additional credit funds, especially bank credit funds, could be made available to potential borrowers, as well as the rate at which consumers and producers would receive further increases in their monetary after-tax income. But as long as the flow of money income and credit is growing as rapidly as hitherto, we cannot expect either consumers to abstain from further increasing their demand for goods and services at the accustomed rate, or producers to abstain from further trying to expand their production facilities at a rate at least sufficient to meet their expectations of future demands for their products.

In fact, the unusually high rate of utilization of plant capacity has induced producers to raise their sights for further expansion over and above the level of previous investment plans, which had been limited by the opportunities for better use of existing underutilized facilities. In consequence, business investment has risen even faster than consumption: between 1964 and the first quarter of 1966, the ratio of private consumption to GNP declined fractionally but the ratio of nonresidential fixed investment to GNP increased from 9-1/2 per cent to 10-1/2 per cent.

Hence, just as the previous state of our economy required a stimulus from both the fiscal and the monetary policy side, the state of our economy since the fall of 1965 has, in my judgment, required restraint, again from both fiscal and monetary policies.

The Federal Reserve System has accepted the policy implications of that analysis. As you know, the discount rate was raised by 1/2 of 1 per cent last December, and the net reserve position of member banks was gradually tightened until these banks had, as a whole, net borrowed reserves averaging about $400 million. Our discount rate now is higher than at any time since 1929, and the new borrowed reserves of member banks are now higher than at any time since 1959.

And, as you also know, this tightening has not failed to exert its influence on the financial markets. The availability of credit for many purposes has been restrained, in the face of surplus demands for funds. In consequence, interest rates have risen sharply. Between September 1965 and July 1966, yields of Treasury bills and medium-term Government securities rose by about 3/4 of 1 per cent and the yield of long-term securities by about 1/2 of 1 per cent; the yields on shares and mortgages rose somewhat less but some bank lending rates, as well as the rates paid by banks on time deposits and especially on the so-called certificates of deposit, rose even more. In order to avert disruption in financial markets from a massive outflow of time deposits from banks, the Board raised last December the maximum rate payable on time deposits from 4 and 4-1/2 to 5-1/2 per cent, and city banks especially have felt compelled to push their deposit rates up to the permitted maximum. In order to stem the resulting shift of funds from other savings institutions to commercial banks, the Board recently raised reserve requirements on time deposits from 4 to 5 per cent--the first increase in reserve requirements since 1951--and also limited rates payable on multiple maturity time deposits.

The rise in interest rates, and the reactions that rise has produced in some quarters, might give the impression that our measures have starved the economy of liquidity. Actually, the opposite is true: the supply of money and credit has continued to expand rapidly--somewhat less rapidly than before, and far less rapidly than it would have in the absence of our action, but apparently still too rapidly for the preservation of price and cost stability and for the improvement, or even for the avoidance of renewed deterioration, of our payments balance.

Again, this result is neither surprising nor mysterious. Once prices generally begin to rise, borrowers quite rightly tend to discount nominal interest rates by the expected rate of the increase in relevant prices. Even though interest rates in money, credit, and capital markets have, over the past nine months, advanced considerably, the rise has been very small if discounted by the increase in prices. And it should occasion no astonishment to find that the movement has therefore been insufficient to induce consumers to increase their savings rate or to induce business to reduce its investment plans as much and as rapidly as would have been necessary to maintain equilibrium between investment demands and flow of savings.

Under these circumstances, two interrelated questions arise: could a more drastic tightening of monetary policy in itself be expected to produce the necessary adjustments unaided by fiscal policy; and if not, does this failure indicate that monetary policy is an inefficient tool with which to maintain or restore financial stability?

Both questions should, in my judgment, be answered in the negative. Monetary policy is a useful tool to counteract moderate deviations from equilibrium; and it is an indispensable tool to assist fiscal and other policies in efforts to remedy a serious disequilibrium; but its use cannot suffice, at least in our own economy, to correct a serious disequilibrium alone and unaided.

Once deflationary or inflationary processes have gathered considerable momentum, quite substantial changes in borrowing plans of producers and consumers are needed to restore equilibrium. In the case of a serious recession, the shortcomings of monetary policy, if unaided by other policies, in trying to generate such substantial changes are generally recognized. But similar limitations also apply to the case of serious inflation.

When everybody expects prices to rise, an increase in interest rates, in order to have a sufficiently restrictive effect, may well need to be greater than the expected price advance. Hence, if everybody expected prices to advance, say, by 3 per cent a year, interest rates might well need to rise by more than 3 percentage points.

But what would happen if the Federal Reserve pursued policies that would rapidly raise interest rates by more than 3 per cent? Would not such a policy be effective?

In fact, it might well be; but it is more likely that it would have unwanted side-effects which would either impair its effectiveness or, even worse, render the action so effective that the boom would turn into a recession.

Let me explain what I mean by this statement.

An action of the Federal Reserve to tighten monetary policy in such a way that interest rates would rapidly rise by more than 3 percent would certainly be considered as signaling a severe financial crisis.

The shock effect of such a signal might be sobering-- in fact so sobering that a great many producers and consumers would immediately reduce their borrowing plans. This would mean a very rapid change in the business situation: the boom would be followed, not be a flattening out of the expansion but by an abrupt contraction. Obviously, such a sequence of events must be avoided.

But this would not be the only risk. In fact, the shock effect might have exactly the opposite consequences. Producers and consumers might become convinced that the rate of inflation was in danger of greatly accelerating if the Federal Reserve felt it necessary to permit such a drastic increase in the bill rate. Instead of reducing their borrowing plans, they might, under these circumstances, actually increase them, thus accelerating instead of slowing down the pace of inflation.

There is no way of reliably predicting the effect of such a psychological shock--not only on potential borrowers but also on the political and institutional framework of our credit system, and on international markets. We must never forget that the international implications of our monetary policy are incomparably more important than those of the monetary policy of any other nation: not only because of our leading role in international trade and even more so in international finance; but primarily because of the widespread use of the dollar as an international currency and as part of the monetary reserves of foreign countries. This consideration alone is a good reason for avoiding drastic experiments.

But let us assume, for argument's sake, that the action of the Federal Reserve would have no untoward psychological, political, institutional, or international consequences. What about its probable impact on our domestic economy?

Moderate changes in monetary policy are unlikely to have serious effects on income distribution. The time has past when only the rich man was a lender and only the poor man a borrower. But potentially serious effects might well appear once the changes ceased to be moderate.

A sharp rise in interest rates has a particularly strong impact on certain sectors of the economy, including residential construction, public utilities, and local authority spending for such vital projects as schools, hospitals, and roads. Manufacturing industries, requiring large inventories, would be more deeply affected than service industries without inventories. The budget of the Federal Government, the largest single debtor of them all, may find its debt service increased by more than its additional revenues. And our balance of international payments would be burdened by the increase in interest payments on nearly $26 billion of fixed-interest dollar liabilities to foreigners.

Moreover, our savings institutions might find themselves in difficulties. Even at present rates, savings institutions feel, in some cases, compelled to pay rates on their deposits that are as high as the yield of previously granted long-term credits, such as mortgages. A further drastic rise in rates might compel them to pay rates in excess of such receipts; or else risk withdrawals of funds. Both alternatives might well lead to disturbing, even disruptive developments: the liabilities of savings institutions are relatively short-term--seldom in excess of one year's maturity--, but their assets may have average maturities as long as 10 years. Hence, their assets cannot easily be liquidated to meet sudden large withdrawals of deposits, and their average credit rates change far more slowly than their average debit rates. Neither the Treasury nor the Federal Reserve could idly stand by while savings institutions go down merely as the consequence of a change in monetary policy. Hence, they would be forced to cooperate in rescue operations. At best, this would mean the lending of substantial new funds to those institutions and their depositors or shareholders. Such operations would avert catastrophe but the injection of newly created funds into the economy would be contrary to the objectives of counterinflationary monetary policy.

Even among enterprises in the same economic sector, serious inequities might arise. Small business would probably have greater difficulties in receiving credit accommodation than large enterprises. And newcomers would have greater difficulties than their old-established competitors, even though the new firms might be more inclined toward technological and managerial innovations. Such a consequence would be particularly serious for our economy which can remain prosperous only as long as it retains its leadership in technology and management.

Consumer credit, little affected by moderate changes in interest rates, also would begin to feel the pinch. Purchase of houses, of cars, and of home appliances might become the privilege of those consumers whose income is high enough to make them independent of credit. In the long run, a gradual reduction in the rate of increase in consumer credit might not be bad for our economy; but an abrupt contraction of consumer lending would be serious for consumers and producers alike.

Sledgehammer action would have equally unfavorable consequences for the Government securities market. The Federal Reserve must not go so far in facilitating effective debt management as to override the interests of the economy as a whole, whenever these interests demand tighter credit conditions. But neither must the Federal Reserve make it impossible for the Treasury to finance Government operations. The Federal Reserve must not arrogate for itself a veto power over expenditures authorized by the Congress even though these expenditures may exceed Government receipts and therefore require new borrowing.

Moreover, even when budget expenditures are fully covered by receipts, the Treasury must have continual access to the credit market in order to turn over its maturing debt. Hence, monetary policy must never imperil the success of Treasury financing operations at the current market rate.

The words "at the current market rate" should be stressed: the Federal Reserve must not peg the price or limit the yield of Government securities. Moderate fluctuations in prices and yields of these securities are essential for the smooth working of our financial markets. But excessively large or violent fluctuations would make the markets disorderly. Under our system, monetary policy is, as you know, primarily conducted by means of operations in the open market, and therefore presupposes the existence of a wide, broad, and resilient market for Government securities. Disorderly markets would make the flexible functioning of our monetary policy itself impossible.

Finally, a drastic change in interest rate levels could produce disturbing price changes throughout our capital-based economy. Interest rates determine the present capital value of future income flows. Hence, a rapid and large decline in interest rates would mean a rapid and large decline in the present value of capital, including not only securities but also plant equipment and real estate. Such a general decline in prices could exert a sharp deflationary influence on the plans of consumers and producers. In this way, an excessive firming of monetary policy would again threaten to bring about a serious downturn of the economy rather than the desired transition from unsustailable boom to sustainable growth rates.

All these considerations do not mean that monetary policy is a tool for fair weather only. While it is not a sufficient means to stem a serious inflation, it is a necessary means to supplement fiscal and other policies to that end.

Restrictive fiscal policies--let us say, an increase in tax rates--would fail in their purpose of ending inflationary pressures if the Federal Reserve were to supply the market freely with the funds needed to pay the increased taxes. The tax increase still would exert some effect, since the taxpayers, while maintaining their liquidity position, would be able to do so only at the price of reducing their net assets. But the tax increase becomes far more effective, and especially its impact on investment decisions much greater, when the increased tax payments press immediately--either fully or at least in part--on the taxpayers' liquidity as well as on their income, instead of being financed by additional borrowing.

Moreover, monetary policy has, as you know, the great advantage of flexibility. Under our Constitution, the power to change tax rates is a jealously guarded prerogative of the Congress; and while it might be desirable for Congress under special circumstances to grant the Executive branch some leeway, it is understandable that Congress has been reluctant to do so. But monetary policy can easily and efficiently be used to modify the severity of the impact of fixed tax rates on the liquidity of the banking system and of the economy in general in line with changes in economic conditions, until these changes are large enough to warrant--and necessitate--further Congressional action.

Finally, the limitations on the effectiveness of monetary policy do not mean that the Federal Reserve would be justified in refusing to take anti-inflationary action in the absence of firming fiscal action. Here as so often, half a loaf is better than none: inflation certainly would have progressed much faster over these past nine months if the Federal Reserve had not firmed its policies.

And in view of the understandable tendency of my audience to see forecasts in anything I say, let me warn you that nothing I say should be interpreted as indicating that the Federal Reserve had reached the end of its rope or that any further firming of its monetary policy would be inadvisable or impossible. But it is my conviction that beyond a certain limit--which we may or may not have reached--further firming of monetary policy alone tends to become less effective than an appropriate combination of monetary and fiscal measures.

Until recently, the interplay of our fiscal and monetary policies has been working remarkably well. We can all take pride in the achievements of the past 5-1/2 years: an unprecedented upswing, accompanied until recently by only minimal increases in prices and virtually no increase in labor cost per unit, and by a gradual improvement in our payments balance. This improvement was by no means as rapid and as complete as we should have wished; nevertheless, since rapid economic progress often tends to raise imports more than exports, it might be considered quite an achievement to have brought about a substantial reduction in our payments deficit at all.

But today we are in grave danger of losing the gains we have made. Inflation is harmful everywhere and under all conditions; but it is particularly harmful here and now. If we lived in a closed domestic economy, or if we were in a comfortable balance-of-payments position, we might for a time tolerate without great harm an annual increase in prices at an annual rate, say, of 3 per cent--most if not all our friends in Europe have

experienced greater price increases over the past few years. But we are living in an open economy, in which the United States is called upon to play a leading role in international commerce and even more so in international finance, and our international accounts have remained in substantial deficit for nearly nine years.

The entire fabric of the international payments system, on which the prosperity of all trading nations of the free world depends, is based on the universal use and acceptability of the dollar. The stability of most other currencies is of importance mainly to their countries of issue since their currencies circulate only at home. The stability of the dollar is of importance to the entire free world since it is used and held virtually everywhere by merchants, investors, bankers, and central banks. Our international payments system cannot be maintained without a stable dollar; a stable dollar cannot be maintained unless we correct our payments imbalance; and we cannot do so if we succumb to inflation, even to a degree perhaps tolerable in countries that do not have the responsibilities of an international reserve center, and whose international accounts are in surplus.

And just as inflation in the United States would have more serious effects on the world economy than inflation in any other country, so an abrupt downturn in our economy would also be more harmful to the entire world than a downturn in any other country. Our economy is distinguished from all others in that the United States is the only country that makes a large contribution to international trade and finance, but whose international transactions, despite their absolute magnitude, are equal to a very small fraction of its domestic sector.

Hence, a downturn in our economy would pose not only great risks to prosperity abroad but would also be unlikely to be effectively stopped by the continuation of prosperity in the rest of the world. For this reason, the United States must take even greater care than other countries to avoid the use of anti-inflationary measures in a way that would risk to overshoot their mark and to bring about a recession. It is no longer true that when the United States sneezes the rest of the world catches pneumonia; but it still is true that if our economy were to become seriously ill, the rest of the world could hardly hope to escape contagion.

For our own sake as well as for the sake of the entire free world, all our efforts need to be directed toward the twin goals of preserving the dynamism of our economy while maintaining financial equilibrium in our domestic and international transactions.

Under present conditions, monetary restraint is an indispensable part of these efforts. But it is only a part and it should not, and cannot, be made to bear the entire burden.