

The Federal Reserve System and U. S. Monetary Policy

(Remarks of C. Canby Balderston, Vice Chairman,
Board of Governors of the Federal Reserve System,
before the Industrial College of Armed Forces on
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Monetary policy has twin goals: domestic and international. The first includes the fostering of economic growth without inflation so that the nation may have a rising standard of living, job opportunities for those able and willing to work, and a dollar of stable purchasing power. The international goal is to achieve equilibrium in our balance of payments.

In seeking these two goals both monetary and fiscal policy are needed. The first has to do with influencing the supply of money and credit and is the responsibility of this country's central banking system--the Federal Reserve. Fiscal policy embraces debt management, which is the Treasury's job, as well as Federal spending and taxes. Of the two, monetary policy is the more flexible and the timing of monetary actions is more precise than is the case with fiscal policy, except that Federal tax receipts move up and down automatically with changes in the state of business.

Since the nation's economic goals are also the goals sought by both monetary and fiscal policy, it is important that they work together smoothly and still keep their respective responsibilities clearly distinguished. To this end, the contacts between Treasury and Federal Reserve officers are numerous and continuous. Each group keeps the other informed of its policy problems and tentative plans; each one gives the other suggestions and views when sought; neither one dictates to the other what action it should take. These informal links are made routine by regular weekly luncheons, as well as by conversations and conferences

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when needed. In short, the agencies function as co-equals.

To initiate my discussion of monetary policy, I shall start with a few comments about money.

By far the most important form of money proper is checkbook money, based on demand deposits in commercial banks. In this country, unlike many others--even those with highly developed economies--check money is over three-fourths of the total. It amounts to nearly \$125 billion of the total money supply of \$158 billion.

If we turn away from these media of exchange to the function money performs as a store of value, we encounter a wide variety of money substitutes or near-monies. These are not money in the narrow sense, but they can be liquidated so readily as to be regarded by individuals and businesses as practically the equivalent of cash. Examples are the savings deposits of individuals and the time deposits of corporations. Included, too, are savings and loan shares, U. S. Savings Bonds and short-term Government securities, to say nothing of such sophisticated forms of corporate liquidity as commercial paper, sale and repurchase arrangements with securities dealers, and placements in the Euro-dollar and other international markets. In domestic forms alone, such liquid assets amount to about \$370 billion, more than double the amount of currency and checking account money outstanding.

So far I have mentioned only money and near-monies, without any mention of credit. But credit is merely the other side of the coin. Credit permits manufacturers and merchants to carry inventory, and their customers to buy before they have saved enough to pay the bill. Credit also finances investment in long-lived assets, such as homes and plant and equipment.

The exchange of ready funds for credit claims is accomplished by having those who would borrow offer those who would save a sufficient inducement to forego the immediate use of their funds and accept the risks involved in the loan of their savings. In consummating this exchange, the function of commercial banks and other financial intermediaries is to stand between the ultimate participants--the savers and borrowers. They perform this intermediary service by obtaining funds from savers and then passing these funds on to individual borrowers; in the process, they themselves take on the credit risks involved. This flow from savers to financial intermediaries to borrowers is only one part of the total savings flow; the other portion travels directly from savers to borrowers in the form of mortgages, bonds and other financial instruments directly acquired.

The proportions of total credit flows moving directly rather than through intermediaries, and the proportions accounted for by the different types of intermediaries, can and do change markedly from time to time. In recent years, the lion's share of total flows has been through the intermediaries, and within this group the banks have done extremely well, mainly from the attractiveness of higher rates of interest paid on time and savings deposits since the beginning of 1962. Greater competitiveness in the savings area accounts for much of the 8.3 per cent annual rate of increase in total bank loans and investments over this period. But commercial banks also have a unique characteristic not possessed by other financial intermediaries; given the necessary reserves, they can create credit to supplement the flow of savings. This is reflected mainly in the growth of checking account balances, which have increased at an annual rate averaging 3 per cent for the first 10 months of 1964.

This monetary growth represents but a small part of the total flow of funds through credit markets. But its importance is much greater than is suggested by the mere dollar amounts involved, because of the credit creation feature. If monetary growth were to be accelerated during a period of vigorous economic activity, with a view to holding interest rates down, for example, the result might be that the additional dollars pouring into the spending stream would mainly tend to raise average prices. This process of monetary inflation would generate expectations of further inflation and thereby tend to increase borrowing and discourage saving. In the long run, monetary policy can contribute to a lower level of interest rates by maintaining a stable value for the dollar. Only in such a climate of confidence will savings accumulate and credit flow in an orderly and expanding volume. In short, Federal Reserve actions cannot for long bring about rates of interest that are either higher or lower than those that balance savings and investment.

This brings me to the role of the Federal Reserve System which is this country's central bank and, accordingly, an institution to which member commercial banks can turn when funds are not otherwise available. The System discharges its monetary role by keeping the reserves supplied to the commercial banks to support checking account balances in tune with the needs of the economy. At some seasons and in some phases of the business cycle the realities of the economic situation call for more bank credit or the reverse. To induce the banks to increase or diminish the volume of bank credit, the Federal Reserve System adjusts the amount of reserves supplied to them.

By releasing or absorbing bank reserves, the Federal Reserve influences short-term and, to a lesser extent, long-term interest rates.

But inasmuch as bank credit is only a portion of the total supply of credit and savings, the influence of the central bank on moneyrates is marginal. Many factors determine credit conditions, trends and rates. On the supply side these include the volume of savings and ^{the} forms that those savings take. On the other side are the kinds and volume of debt instruments issued by the U. S. Treasury and other borrowers--in short, the nature and extent of demands for credit by its users.

Reflecting the growth of our economy and the scale of its operations, a truly mammoth increase has taken place in total savings and credit flows in recent years. The total of credit funds obtained by the nonfinancial sectors of the economy, for example, amounted to \$59 billion in 1962, \$64 billion in 1963 and more than \$68 billion at annual rates in the first half of the current year. Financial saving has been equally large, and often has tended to outrun even these gigantic credit demands. The result is that funds have been readily available, for virtually all purposes, on liberal terms and at relatively moderate rates, throughout the current business upswing. In fact, it has seemed to some that terms might be too liberal and credit too readily available in certain areas for the preservation of the quality of credit.

The art of commercial banking is to achieve and keep a balance between prudent safety and profitable risk. In this country the allocation of credit is arranged through the marketplace. It is the result of the higgling between lenders and borrowers. The result is that the supply of money and credit flows to those users who are willing to bid the most for it. But bidding for credit accommodation is not a mere matter of price or rate; it is a matter of rate in relation to risk. Each lender is faced continually with the problem of balancing the need to venture his capital,

if he is to make it fruitful, with the need to minimize his risk, if that capital is not to be impaired. How far to venture and still be prudent is his perennial concern.

The quality of credit is influenced by the ability of private sectors of the economy to take on debt. The economy's absorptive capacity turns not only upon the size of the debt burden but also upon the latter's distribution to individual firms and customers; it turns upon the terms of the indebtedness as well as upon the earning capacity of the borrowers. But it is not the soundness of the individual project alone that is in question; the ebb and flow of general business conditions also influences loan quality. Ever since World War II, rising prices and values and a generally favorable economic environment have salvaged many a loan or investment that otherwise might have turned sour. As has often been said, a lender never intentionally makes bad loans; they just go bad afterward. While the individual lender or borrower has no control over general business conditions, he must still attempt to take them into account. The large increases in private indebtedness in recent years bear importantly on such planning.

The Federal Reserve System, as the central bank of the United States, has a balancing act of its own. As indicated already, it is to supply to the commercial banking system a volume of reserves that is neither too large nor too small. These reserves influence the volume of credit banks can create to supplement the flow of savings from savers to borrowers. Since the volume of bank credit needs to be kept attuned realistically to the needs of the economy--as they grow over time and fluctuate with the seasons and with the cycle--the central bank has the continuous problem of determining the volume really needed for constructive purposes.

Hence the Federal Reserve should supply enough reserves for healthy economic growth, but not so much as to induce speculative excesses. The System at its own initiative makes reserves more or less available through open market operations. If the System buys Government bonds, bank reserves are increased thereby. If the System sells bonds from its big portfolio, reserves are decreased. The member banks at their own initiative may supplement reserve availability by borrowing from the Federal Reserve Banks. If the total reserves available exceed what the member banks are required to keep, the difference is excess reserves, which have tended to be around \$400 million of which the major portion is held by the country banks. Member banks are required to hold from 12 to 16-1/2 per cent of their demand deposits and 4 per cent of their time deposits as required reserves.

When the borrowings from the Federal Reserve are high, as they were in 1959, and larger than the excess reserves, then member banks as a whole are in what we call a "net borrowed reserve position." When individual banks find themselves continuously in debt to the Federal Reserve because of their inability to meet their reserve requirements, they are under some pressure, both from the Federal Reserve and from their own banking traditions, to reduce their indebtedness to the central bank, which is the bank of last resort. Conversely, when borrowings from the Federal Reserve are low enough so that banks have net free reserves, as shown by the black areas on the chart, banks seek lending opportunities more avidly and interest rates tend to decline or to stay low. This explains the near record expansion of bank credit during 1963 when it rose \$19 billion or 8 per cent.

Reserves have been needed to support the rapid growth in time deposits--though such requirements are much lower than for checking accounts--and the Federal Reserve has provided these reserves. In this sense, as well as through the gradual increase permitted in checking account balances, the monetary authority has accommodated the growth in credit on liberal terms. Without the reserves that were provided, there could not have been so much of an expansion of bank deposits or so full an accommodation of bank credit demands. Thus, monetary policy can be said to have remained "easy", in furtherance of the national objectives of maximum growth in employment and in the economy, at relatively stable prices. At the same time, the constraint of a continuing large balance of payments deficit prevented any move toward even greater ease, and short-term interest rates have been permitted to work upward in order to maintain a reasonable parity with money rates available on short-term investments abroad.

The principal consideration permitting continued monetary ease is that the current expansion has exhibited characteristics that are different from previous ones. Wholesale prices have remained remarkably stable, reflecting a number of factors not present in the middle 1950's, or in 1959. One is the absence of inventory speculation. With prices stable and production capacity ample, purchasing agents have been able to rely upon assured supplies of materials. Another very favorable factor has been the continued rapid increase in productivity per man hour. On the basis of earlier cyclical experience, one would have expected improved productivity only during the first year or so of recovery and then a tapering off. But productivity has continued to rise at about a 4 per cent

rate in manufacturing, even though the current expansion has continued for nearly four years. The result, in combination with moderation in wage rate advances, has been to keep unit costs and prices stable. Whatever be the underlying cause of this fortunate outcome, it has served to enhance the competitiveness of American firms relative to those abroad.

This brings me to the problem of our adverse balance of payments and the resultant outflow of gold, which has become since 1958 of continuing concern to monetary policy. Other industrialized nations, such as Great Britain, have long recognized the necessity of maintaining international equilibrium in their balance of payments. But for many years our problem had been different, because this country held the major portion of the gold stock of the Western World and also possessed the productive capacity to reequip the devastated nations. So, until 1958--that turning point--the United States was concerned about a "dollar gap", as the lack of sufficient dollars in foreign hands was called. But the tide turned when European nations achieved currency convertibility. As their accumulation of reserves in the form of gold and dollars has mounted since that time, so has their financial power.

It has been necessary that our fiscal and monetary policy making should reflect the need to maintain world confidence in the integrity of the dollar. Serving as a reserve currency, and therefore as an alternative to gold, the dollar plays such a vital role in lubricating international trade that loss of confidence in it would be damaging both to the Western World as a whole and to the United States. An adverse balance of payments means to a foreign observer that our exporting is not large enough to pay for the investing, lending, and spending that our Government and its citizens do abroad.

Our country has had an adverse balance in each year since 1950 except for the one year of 1957. During recent years the figure has been between \$3 and \$4 billion if one excludes prepayment of debt. The consequent accumulation of foreign claims upon our liquid dollar assets has increased especially fast when interest differentials induced American and foreign holders of funds to invest them elsewhere, or when speculators preferred to hold gold or some foreign currency instead of dollars, or some foreigner delayed debt repayment to an American firm in the expectation that the dollar would become cheaper. At times the outflow of gold was strong, as in 1958, when the figure reached \$2.3 billion; at other times, as in 1959, the outflow was small even though foreign claims continued to mount. Fortunately, our exports have been exceeding our imports by a healthy margin, thanks to the boom in Europe and Japan. But this sizable balance in our current accounts has not been sufficient to offset the outflow of private capital associated with American investment abroad, and from the borrowing by foreigners from our American banks, plus our vast governmental expenditures and lending abroad.

Inducing other nations to assume a significant portion of the military expenses of the Western World and of the capital needs of underdeveloped countries, is a task for our State and Defense Departments; it is beyond the compass of my discussion, and so I shall turn to the other side of the equation, the increasing of our trade balance so that we can improve our ability to pay for our foreign investing, spending, and lending.

The essential point is that our exports must exceed our imports sufficiently to pay for our new investments abroad, plus the military expenditures and economic aid across the seas that our world leadership seems to entail. This means producing goods of the right design and

quality offered at the right terms and prices. The prices that count are the export prices of the world and not the prices at home.

It is time, therefore, to take stock of our wage-setting and pricing policies to the end that the prices quoted may promote the export trade needed to finance our country's obligations. The problem is similar with respect to imports entering our markets. It cannot be solved by raising tariffs and other obstacles to free competition. Such devices do not cure the cost differentials that are the seat of our difficulties. Moreover, we cannot export freely if we do not import freely because nations would erect retaliatory barriers and prevent us from achieving the trade surplus needed to finance our overseas activities.

These things that I am talking about are the real fundamentals to the economic health and strength of our country. Dr. Arthur Burns, in a talk to the American Iron and Steel Institute, gave them the following prescription which seems to me worth noting:

"Unless the government moves prudently in increasing the money supply and its own rate of spending; unless trade union officials keep their demands for wage increases from exceeding improvements in general productivity; unless the government refrains from passing laws that raise wages or prices; unless business firms and trade unions join in efforts to remove restrictive labor practices and the featherbedding in which both executives and workers sometimes indulge; unless the

"government reforms our tax system in the interest of stimulating greater effort, more productive investment and higher efficiency; unless businessmen innovate vigorously and lower prices whenever possible; unless these things are done and a liberal policy toward imports is continued, we will not avoid new and successive rounds of inflation."

Dr. Burns' prescription involves hard thinking and hard decisions both for business and labor and for government. The quality of these decisions is especially vital to our American economy with its fragmented decision-making. Such fragmentation may appear inefficient to some, but in the long run it is one of our great strengths. Take the lesson of Hitler's extreme centralization. Maynard Keynes once observed that Hitler centralized Germany's decision-making to the point that the only mistakes he could make were major ones.

Confronted with the two sets of objectives mentioned at the outset--the domestic and the international--the Fed must walk a very narrow path between enough and too much. Excesses at home would lead inevitably to lost confidence abroad and to the unwillingness of foreigners to hold dollars as a supplement to gold. Not only is the dollar the lubricant to continued growth of world trade, but the reserve currency that anchors the domestic currencies of the countries of the West. For us to display prudent financial husbandry is therefore vital both to ourselves and to our trading partners.

SELECTED MONETARY INDICATORS

RESERVES, BILLIONS OF DOLLARS

WEEKLY AVERAGES

RATES, PER CENT PER ANNUM

