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RECENT TRENDS IN AMERICAN MONETARY POLICY

Remarks by

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Before

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of the

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RECENT TRENDS IN AMERICAN MONETARY POLICY

The extent to which money and credit have come under restraint in the United States in recent months is not fully realized in many quarters. This is true of numerous observers at home as well as abroad. Undoubtedly, there are several explanations of this failure to appreciate the sharpness of the change in Federal Reserve policy from a posture of ease to one of restraint.

- In the first place, I suspect that a great many of even the close observers of the U. S. monetary scene (especially observers abroad) have not examined the statistical evidence carefully - with a clear view of the ways in which monetary restraint actually works in this country.
- Secondly, particular instruments of monetary restraint apparently have not been used in the exact way (or to the same extent) a number of market participants expected (or hoped). This seems to be especially true of the Federal Reserve discount rate.

Against this background, a brief review of recent developments in monetary policy in the United States would be in order. It will be recalled that monetary policy shifted overtly toward greater restraint late last Fall. The objectives were to resist rising inflationary pressures at home and to contribute to improvement in our balance of international payments. It will be recalled also

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that monetary policy in 1967 eased substantially. The aims were to accommodate a sizable adjustment in business inventories and a moderation in business fixed investment, as well as to encourage a recovery of housing from its severely restricted level of 1966. Although monetary policy remained relatively easy through much of 1967, interest rates rose sharply, and long-term rates exceeded their 1966 highs. To a considerable extent, this sharp climb in market yields reflected the continuation of a large deficit in the Federal budget and the corresponding need for the Government to borrow heavily. It also reflected record flotations of securities by corporations, many of which entered the market because of expectations of still higher interest to come in view of the magnitude of the continuing deficit.

Recognizing these influences - the size of the Federal deficit and the prospects for continuing inflation - many officials in the Federal Reserve System joined those (both in and out of Government) who strongly urged an increase in Federal income taxes and a reduction in Government expenditures. As 1967 wore on and the tax proposal failed to move, the Federal Reserve System shifted to a policy of monetary restraint. To some extent, international developments also influenced the timing of the shift and the choice of policy instruments employed.

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Policy Actions

In pursuing a policy of restraint, the Federal Reserve has used all of its policy instruments in a coordinate fashion:

- The discount rate was raised from 4 to 4½ per cent in mid-November, just after the devaluation of sterling. The rate was raised again to 5 per cent in mid-March as part of a package of moves to deal with the speculation against the official price of gold.
- Reserve requirements on demand deposits were raised in mid-January by ½ percentage point on the amount at each bank above $5 million. This action had the effect of absorbing about $550 million of reserves.
- Open market operations have been aimed at attaining firmer monetary conditions and a slower rate of credit expansion. At the same time, there has been no interference with the successful marketing of a considerable volume of new Treasury issues.
- As market yields have risen, the maximum rates of interest which member banks can pay on certificates of deposits have not been raised. This, too, has had a moderating influence on the expansion of bank credit. (However, one should not conclude from this observation

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that none of the ceilings would be raised if market developments make such an action warranted to maintain stability of the banking system).

While I certainly do not intend to boast about the Federal Reserve System's performance, I must stress that the above monetary actions have been taken in a deliberate and moderate way. The objective has been to restrain the growth of bank credit and the money supply without creating excessive strains on the nation's financial fabric.

Money and Credit Flows

The effects of these policy actions can be seen in a number of statistical measures:

Per Cent Rates of Change in Monetary Indicators for Selected Periods

Series - Seasonally Adjusted	May '67- Nov.'67 1/	Year 1967	Dec. '67- Feb. '68 1/	Dec. '67- Mar. '68 1/
Total reserves	9.6	9.8	7.5	6.7
Nonborrowed reserves	10.0	11.5	4.7	0.5
Bank credit proxy(2)	11.3	11.6	6.0	5.6
Time deposits	14.7	15.8	5.4	6.7
Money supply	8.4	6.5	4.0	3.5

1/ Dates are inclusive.

2/ Total member bank deposits.

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Bank credit expansion, which amounted to 11.6 per cent in 1967 as a whole, slowed to less than 7 per cent in the final quarter of the year. In the four months December through March, the growth of bank credit has slowed further to an annual rate of 5.6 per cent. While there were month-to-month fluctuations reflecting Treasury financing, the trend of credit expansion has been definitely downward. The expansion of the money supply since the end of last November has been about half as large at an annual rate as in 1967 as a whole, a decline from 6.5 per cent to 3.5 per cent. The more moderate rate of credit growth also has been shared by time deposits at commercial banks.

While total reserves have grown by roughly 6.7 per cent in the last four months, the rise has occurred almost entirely through member banks borrowing from Federal Reserve Banks; there has been virtually no net growth in reserves supplied directly by the central bank. This sharp check on the expansion of bank reserves has been achieved despite the fact that the Federal Reserve has had to supply reserves to cushion the impact on the domestic banking system of the substantial outflow of gold.

The composition of bank credit has also changed substantially in recent months. At all commercial banks, total loans and investments, on a seasonally adjusted basis, were virtually unchanged in March. These had risen by an annual rate of roughly 14 per cent

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CHANGES IN BANK CREDIT
All Commercial Banks
(Seasonally adjusted annual rate, per cent)

	1967		1968	
	1st half	2nd half	Jan.-Feb.	Mar.1/
Bank loans and investments	9.9	11.5	13.9	-0.3
U.S. Gov't. securities	6.3	16.6	18.0	-27.2
Other Securities	31.2	14.6	18.9	17.3
Total loans	10.9	7.2	7.7	11.0

1/ All March figures are preliminary estimates based on incomplete data and are subject to revision.

in January-February combined. The cutback can be traced to several factors. While these banks added to their holdings of Government securities at an annual rate of 16.6 per cent in the second half of last year - and increased the pace to 18 per cent in the January-February months - there was a net liquidation of such issues in March at a 27 per cent annual rate. To a considerable extent, these changes reflected Treasury financing patterns. Bank holdings of other securities (particularly of state and local government issues) appear to have grown slightly less rapidly in the last month.

Total loans expanded rather rapidly in January-February. Much of the strength centered in loans to securities dealers who in turn had to handle a greatly enlarged volume of new Treasury issues. In March, security loans declined by an estimated $1 billion.

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The growth of business loans at banks has been relatively moderate in recent months - despite a somewhat more rapid rise in March. This has come as a surprise to many bankers - many of whom had built up their liquidity early in 1967 in anticipation of a strong surge in business borrowing. The more rapid growth of business loans in March occurred late in the month and was centered in New York City. Moreover, almost half of the increase was in bankers-acceptances.

It seems that corporate demands for bank financing to cover the March tax and dividend payments were lighter at New York City banks than in previous years. At large weekly reporting banks outside New York, however, such loan demands were somewhat stronger than in earlier years in relation to total tax payments.

Interest Rates and Savings Flows

Short-term interest rates, which had climbed steadily from mid-1967, accelerated following the increase in the discount rate last November. In late January, however, a slight easing occurred in these yields - partly reflecting seasonal factors. Since then, short-term rates resumed their upward climb. For example, by mid-March, three-month Treasury bills were yielding 5.45 per cent, compared with 4.82 per cent at the end of January; their 1967 high was 5.07 per cent (attained in mid-December), and the high point in 1966 was 5.59 per cent, registered in the third

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week of September during the period of considerable money market pressures. Following the President's weekend statement announcing a lessened pace of military activity in Vietnam, coupled with a renewed appeal for fiscal restraint (as well as renewed efforts in Congress to bring about the latter), market yields eased off slightly. However, three-month bills were still yielding 5.20 per cent on Tuesday of this week.

Large denomination certificates of deposits (CD's) of 30-day maturity are at the 5½ per cent ceiling set by the supervisory authorities. As recently as early March, three-month CD's were being offered at 5-3/8 per cent, and the ceiling rate applied only to six-month maturities. While no serious attrition has developed so far in commercial banks' large denomination CD's outstanding, some banks may be encountering resistance in the issuance of new offerings. There is some evidence suggesting that outside of New York the amount of CD's turned in around the mid-March tax date was particularly large. Moreover, during a period when banks usually add to their deposits in preparation for large April tax maturities, CD's outstanding in New York apparently has changed little in recent weeks, while in Chicago an actual decline seems to have occurred.

As indicated above, other types of time and savings deposits at commercial banks have been growing less rapidly.

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There is also some evidence that inflows at institutions other than commercial banks have moderated as well. New York City savings banks experienced a considerably larger withdrawal of funds around the April reinvestment period than they did in the same period last year. To some extent the more adverse experience this year undoubtedly resulted from the pull of a Federal agency security offered in late March at an extremely attractive yield.

Long-term interest rates, which receded in February from the exceptionally high levels reached in late 1967, have moved up again. New corporate issues of the highest investment quality and with call protection were being marketed this week at 6.60 per cent. This was almost ½ point above the 6.16 per cent level in early February; such an issue yielded 6.55 per cent at the 1967 peak reached in early December. Even during the period of credit stringency in 1966, such high grade corporate issues were sold at lower yields (the peak was 5.98 per cent set in early September). The decline in long-term corporate yields early this year reflected in part a reduction in expected new corporate issues from the unprecedented monthly volume recorded in 1967. Although the current volume remains below those earlier levels, market flotations are still substantial.

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Monetary Policy in Perspective

As stressed above, monetary policy is currently exerting considerable restraint on the nation's economy. Moreover, because of the time lags involved before the impact of monetary actions is registered on spending decisions in the private economy, the steps already taken will be producing results through the months to come. Nevertheless, with domestic inflation having already made considerable headway - and with the deficit in the U. S. balance of payments remaining a serious problem -- the proper stance for monetary policy is a posture of restraint. On the other hand, it is also of highly critical importance that fiscal restraint - through an increase in income taxes and a reduction in Federal spending, in that order - be made to bear a much larger share of the responsibility for the stabilization of the national economy. The renewed efforts to bring this about as exemplified by the adoption of the tax and expenditure measure in the Senate by a large majority this week, is a welcome development. Yet, until some meaningful version of the bill actually becomes law, our arsenal for fighting inflation remains dangerously depleted.

With respect to the instruments of monetary policy, as I mentioned above, these have been used in a coordinated fashion to bring about restraint. While the discount rate has been raised twice since the middle of last November and reserve requirements

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have been increased by over $500 million, open market operations have been the principal instrument for effecting credit restraint. For example, nonborrowed reserves have shown virtually no net growth since last November. As one would expect during a period of restraint, member bank borrowing from Federal Reserve Banks has averaged over $600 million for a number of weeks. In fact, on an average basis, such borrowing has outpaced excess reserves by more than $300 million for several weeks. Again, these developments are consistent with a policy of restraint.

On the other hand, many observers apparently still feel that a Federal Reserve discount rate increase greater than ½ per cent (which raised the rate to 5 per cent in mid-March) was necessary to demonstrate that monetary policy was determined to play its part in combating domestic inflation and helping to defend the dollar abroad. In fact, according to newspaper accounts, some observers apparently even thought a 6 per cent discount rate was required to demonstrate this determination. In my personal view, the ½ point increase adopted was entirely proper - given the interplay of both domestic and international forces. It should be recalled that the mid-March discount rate advance was one of a number of measures designed to check speculation against the dollar in the short-run. The basic problem - the persistent deficit in our balance of payments - must be dealt with through fiscal measures which bear

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directly on domestic spending. Undoubtedly, discount rate changes can - and should - play a role in the spectrum of monetary policy instruments. However, we should bear in mind the domestic - as well as the international - impact of such moves. While the domestic economy requires restraint, it is also necessary to exercise this restraint with moderation.

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