For Release on Delivery
Thursday, May 2, 1968
12:00 Noon, E.D.T.

UNITED STATES MONETARY POLICY IN PERSPECTIVE

Remarks by

Andrew F. Brimmer
Member
Board of Governors of the
Federal Reserve System

Before the

Annual Convention
of the
Ohio Bankers Association

Commodore-Perry Hotel
Toledo, Ohio

May 2, 1968

UNITED STATES MONETARY POLICY IN PERSPECTIVE

Once again, monetary policy is virtually the only force engaged in the campaign against inflation in the United States. This is both unnecessary and unfortunate. It is unnecessary because the need for restraint on the pace of economic activity during the current year was clearly foreseen well over a year ago, and the President called for the enactment of a 10 per cent surtax on personal income as the principal instrument of stabilization. It is unfortunate because the uneven impact of monetary restraint is widely known. Nevertheless, since Congress has so far refused to adopt an increase in income taxes or to reduce low-priority Federal expenditures, monetary restraint remains the only means of coping with growing inflationary pressures.

The increase in the Federal Reserve Banks' discount rate to 5-1/2 per cent and the increase to 6-1/4 per cent in the maximum interest rates payable by member banks on time deposits over $100,000, effective April 19, were both further steps in this effort. Currently, the discount rate is at the highest level recorded since the 6 per cent registered for a few months in the summer of 1929; the ceiling on rates payable on time deposits is the highest ever allowed since the Federal Reserve Board was empowered to establish such rates in 1933.

For me personally, these latest steps toward credit restraint posed an agonizing question. In the first place, the degree of restraint already exerted through monetary policy is substantial, and the effect will undoubtedly be felt over the months ahead. On the other hand, the inflationary pressures in the economy are also substantial. While I personally would have preferred that a greater share of the necessary effort to counter inflation be provided by fiscal policy, to date this has not been the case. Under these circumstances, it was clearly necessary for monetary policy to move still further in the direction of restraint.

In these remarks, I shall try to put into perspective the latest moves toward further restraint.

- First, I shall summarize the main policy actions taken since last November.
- Second, the economic framework of monetary policy will be sketched.
- Third, the impact of monetary restraint to date will be indicated.
- Finally, the implications of prospective economic developments for monetary policy will be assessed.

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 4-1/2 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. It was raised again to 5-1/2 per cent effective April 19.
- Reserve requirements on demand deposits were raised in mid-January by 1/2 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 large denomination certificates of deposits were raised effective April 19. However, the higher ceilings were tied to maturities: 30-59 days, 5-1/2 percent; 60-89 days, 5-3/4 per cent; 90-179 days, 6 per cent, and 180 days and over 6-1/4 per cent. Moreover, rate ceilings on passbook savings and on time deposits of less than $100,000 were left unchanged.

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.

Economic Framework of Monetary Policy

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 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.

The need for restraint was demonstrated anew by the enormous burst of economic activity during the first quarter of this year. As is generally known, the gross national product (GNP) rose at an annual rate of $20 billion, or an annual rate of growth of 10 per cent in current dollars. However, prices rose at an annual rate of 4 per cent so that the expansion of real output amounted to 6 per cent. Moreover, the composition of the expansion in output in the first quarter is as disturbing as the pace of economic activity itself. If allowance is made for the slower rate of accumulation of business inventories, final sales to households and businesses actually increased at an annual rate of $25 billion in the first quarter. Expenditures by consumers rose at an annual rate of $16 billion in the same period -- the largest quarterly increase on record. While a significant share of the rise in consumer outlays can be traced to a sizable increase in personal income, there was also a sharp decline in the ratio of savings to disposable personal income -- from 7.5 per cent in the final quarter of last year to 6.8 per cent in the January-March period. Given these changes, plus other underlying forces affecting economic activity, it seems evident that the economy will continue to expand at a rapid pace in the months ahead. It also seems evident that inflation will continue to be a serious problem.

Impact of Monetary Restraint

The effects of monetary restraint can be seen in a number of statistical measures. The most important of these are summarized in Table 1. It will be noted that total reserves rose at an annual rate of 4.6 per cent during the last five months, slightly less than half the rate of expansion recorded in 1967 as a whole. Perhaps of even more importance, the Federal Reserve on balance has absorbed bank reserves rather than expanding them; borrowings by member banks have exceeded the rise in total reserves since the end of last November. The growth of total reserves has been held in check despite the fact that the System found it

Table 1. Per Cent Rates of Change in Monetary Indicators for Selected Periods

Series - Seasonally Adjusted	May '67- Nov.'67 1/	Year 1967	Dec.'67- Mar.'68 1/	Dec.'67- Apr.'68 1/
Total reserves	9.6	9.8	6.5	4.6
Nonborrowed reserves	10.0	11.5	-0.4	-1.2
Bank credit proxy 2/	11.3	11.6	5.5	3.7
Time deposits	14.7	15.8	6.7	5.5
Money supply	8.4	6.5	3.6	5.6

1/ Dates are inclusive.
2/ Total member bank deposits.

necessary to purchase over $2 billion of Government securities to cushion the reserve impact on the domestic banking system of the substantial outflow of gold.

Bank deposits, in the last five months, has slowed to an annual rate of growth of 3.7 per cent, just over one-quarter that registered last year. Within the period, there were month-to-month fluctuations reflecting Treasury financing, but the trend has been definitely downward. Between the end of November and the end of March, the money supply expanded at an annual rate of 3.6 per cent; this was a growth rate about half that for 1967 as a whole. Reflecting both rapid growth of currency in circulation and large net transfers from U. S. Government to private demand deposits, the money supply rose sharply in April, thus partly offsetting the substantially slower pace of expansion during earlier months. The inflow of time deposits at commercial banks has also slowed noticeably; for the five-month period ending in April, the annual rate of expansion (at 5.5 per cent) was about one-third that recorded for 1967.

In the last month or so, the composition of bank credit has changed appreciably. (See Table 2.) While total loans and investments rose rapidly in January and February (at an annual rate of 12 per cent), there was a modest decline in March; for the first quarter as a whole, the rise was 6.8 per cent at an annual rate. The slow-down in March centered almost entirely in the sizable liquidation of U. S. Government securities; in January-February, the banks had substantially enlarged their holdings of

Table 2. CHANGES IN BANK CREDIT
All Commercial Banks
(Seasonally adjusted annual rate, per cent)

	1967		1968	
	1st half	2nd half	I Qtr.	April 1/
Bank loans and investments	9.9	12.5	6.8	8.5
U.S. Gov't securities	6.3	15.2	2.0	-12.0
Other securities	31.2	18.1	13.7	- 1.9
Total loans	5.9	10.3	6.4	16.3
Business loans	10.9	8.2	7.0	17.8

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

Governments. To a considerable extent, these variations reflect the changing pattern of Treasury financing.

In the last month, however, the expansion of bank credit has originated in the growth of loans rather than investments. The rise in business loans has been particularly sharp. At an annual rate, the month-by-month growth was: January 2.8 per cent; February 6.9 per cent; March 11.0 per cent, and April 17.8 per cent. Thus, the April rise was 2-1/2 times the 7.0 per cent recorded in the first quarter. There has also been considerable broadening in the sources of business loan demand at commercial banks. While corporate demands for bank financing to cover March tax and dividend payments were lighter at New York City banks than in previous years, such demands in the rest of the country were somewhat stronger than in earlier years in relation to total tax payments. In April, partly to obtain funds for tax payments, corporations allowed an unusually large volume of finance company paper to run off, and a number of finance companies had to borrow heavily from commercial banks. There was also a quickening in demand for loans by industrial and mining firms -- aside from borrowing for tax purposes.

Interest Rates and Deposit 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-April, three-month Treasury bills were yielding 5.46 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 week of September during the period of considerable money market pressures. Following the President's statement at the end of March 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, after the increase in the discount rate effective April 19, yields on most short-term money market instruments rose 10 to 15 basis points.

By the time the maximum rate was raised on April 19 on time deposits over $100,000, yields on large denomination certificates of deposits (CD's) of 30-day maturity were at the 5-1/2 per cent ceiling set by the supervisory authorities. Even as late as the eve of the tax date in March, three-month CD's were being offered at 5-3/8 per cent, and the ceiling rate applied only to six-month maturities. However, as other market yields rose, the banks found it increasingly difficult to attract funds through CD offerings. Between mid-March and mid-April (encompassing the two tax dates), CD's outstanding at commercial banks declined by more than $1.5 billion. The decline was particularly heavy at large banks whose potential CD customers are also normally investors in competing money market paper. It was partly to moderate the attrition in CD's that the ceiling on the larger units was raised on April 19.

Attrition in consumer-type savings deposits has also been recorded recently at large commercial banks. The growth of these deposits slackened considerably in the first quarter, and an actual decline of $475 million occurred over the first three weeks of April. At the same time, there has been little offsetting growth in consumer-type time deposits. Inflows to nonbank institutions has also moderated.

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 in the last week in April at 6.66 per cent. This was 1/2 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). Following the increase in the discount rate effective April 19, corporate yields advanced about 20 basis points. 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.

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 in early April was a welcome development. Since then, however, a full month has elasped without final Congressional approval. 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 coordinate fashion to bring about restraint. While the discount rate has been raised three times since the middle of last November and reserve requirements 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 no net growth since last November. Member bank borrowing from Federal Reserve Banks has averaged over $660 million in both March and April. In fact, on an average basis, such borrowing has outpaced excess reserves by more than $325 million in both months. Again, these developments are consistent with a policy of restraint. How long such a posture will have to be maintained obviously cannot be forecasted. On the other hand, it should also be obvious that the future course of monetary policy will depend heavily on the conditions brought about by the interplay of private spending decisions, Congressional decisions relating to Federal tax and expenditures policies, and the consequent size of the Federal deficit and the Government's need to borrow in the money and capital markets.