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MONETARY POLICY ISSUES IN 1969

Remarks By

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While I obviously cannot forecast the course and content of monetary policy in the year ahead, it is possible to identify a number of developments already unfolding that must necessarily have a high priority on the agenda of the monetary authorities. In my personal judgment, the most critical issues will be posed by the performance of the national economy during the first half of 1969; fiscal and debt management policies, and the deficit in the U.S. balance of payments. Of course, another member of the Federal Reserve Board or of the Federal Open Market Committee might select a different ordering of the issues -- and may well add others. However, I am confident that all would agree that the task of monetary management in 1969 will be no less interesting than it has been in 1968.

As I look ahead to the next year -- and without attempting to make detailed forecasts of gross national product or other measures of economic performance -- I view the three issues identified above in the following perspective:

- With respect to economic performance, I expect a somewhat slower rate of growth of output and employment in the first half of 1969, followed by a quickening of activity after mid-year. Such a profile of economic activity would be similar to that which evolved in 1967 -- at least in direction if not in precise degree and composition.

  But we should remind ourselves that the experience last year was far from ideal: the slowdown in the first half of the year was desirable because it did permit us to bring about at least a temporary moderation in the pace of inflation. However, it is also clear that the economy rebounded too rapidly in the closing months of the year, and inflationary pressures were stimulated anew.

In the year ahead, it will be vital that we conduct our stabilization policies (including monetary policy) in a manner to insure moderation in economic performance throughout the year. Our aim should be a very modest growth in real output during the first half of 1969 followed by a somewhat faster rate of expansion in the second half of the year -- but not so fast as to generate a new wave of inflationary pressures.

- Fiscal and debt financing postures should make a significant contribution in the first half of calendar 1969 in our general efforts to bring inflation under control. The surtax enacted in June of this year, the higher social security taxes to be effective next January, and some moderation in the rate of increase in Federal Government expenditures will clearly be helpful. In view of the sharp reduction in the Government's deficit expected during the current fiscal year, there should be a substantial reduction in the demands placed on the capital market by the U.S. Treasury.

  However, for the second half of 1969, the outlook is far less clear with regard to our fiscal posture. The surtax is a key element underlying the favorable outlook for the first half, and it is scheduled to expire next June 30. Whether this fiscal measure will be allowed to lapse is obviously a question to be decided by the Administration and the Congress, and undoubtedly the status of the Vietnam War as the new year unfolds will be a major factor in their decision.

  Nevertheless, if the Vietnam War is still in progress, I am personally convinced that the presence or absence of the surtax will mean that the Federal Government's borrowing problems will be eased or aggravated during the fiscal year beginning next July 1. Its presence or absence would obviously be a vital factor shaping the course of monetary policy.

- The coming year undoubtedly will open with a continuation of the persistent deficit in the U.S. balance of payments. Hopefully, however, it will be smaller than that prevailing as the current year began. How the deficit will behave in 1969 will depend heavily on the pace of economic activity abroad as well as in this country and on the status of the Vietnam War.

But an important influence on our balance of payments performance in 1969 will be exerted by the Administration's programs limiting the outflow of funds for direct investment and bank loans to foreign borrowers. While I obviously cannot comment on the nature and content of these programs for 1969, I am personally convinced that both programs will be needed if we are to make adequate headway in shrinking the deficit in our balance of payments.

But aside from the restrictions on bank lending abroad, the monetary authorities can (and undoubtedly will) contribute toward progress in the restoration of payments equilibrium through the conduct of general monetary policy.

I will turn to a fuller assessment of each of these major issues. But let me stress again that I am speaking for myself -- because other members of the Federal Reserve Board and of the Federal Open Market Committee obviously can speak for themselves.

Monetary Policy and Economic Performance

The rate of economic growth will probably be very small in the first half of 1969. This has been a prime aim of both monetary and fiscal policy in recent months; and from the present vantage point, it seems to me that the objective will be accomplished.

I reach this conclusion despite the fact that the response of some key sectors of the economy to the surtax which became effective in July has apparently been delayed. This is especially true of the consumer sector. In both July and August, retail sales were about 10 per cent higher than in the same months a year ago. In August, the unemployment rate declined to 3.5 per cent from 3.7 per cent in July. Private housing starts in July were at an annual rate of 1,539,000, compared with 1,349,000 in June. The index of industrial production in July rose by 0.6 of a point to 165.3, and declined slightly in August. Statistics such as these have caused some observers to question whether the economy will grow more slowly in the second half of 1968 and in the first half of 1969.

I do not share those doubts. My assessment of the economic outlook suggests a definite weakening in the main sources of excessive expansion in the economy during the January-June months of this year, and I see no autonomous changes which are likely to provide an off-setting stimulus. The increase in GNP in the first half of this year was just over $40 billion, but the gain during the final six months will probably be much more moderate. Purchases of goods and services by the Federal Government, which rose at an annual rate of 13 per cent during the January-June months, may show a rate of gain less than half as large during the final six months. Business fixed investment rose by just under 7 per cent at an annual rate in the first half, but the gain in the second half may be less than 3 per cent at an annual rate. Investment in business inventories was at an annaul rate in excess of $10 billion in the first half; however, mainly because of the run-off in steel stocks, the rise in inventories during the second half will probably be somewhat below that recorded in the January-June period. Even in the consumer sector, about which the most doubts have been expressed recently, the outlook is for a considerably reduced rate of expansion over the rest of this year. While personal consumption expenditures rose by an annual rate of 10 per cent in the first half, the advance in the second half may be considerably smaller. Although the surtax will slow the growth in consumer spending, income increases are still strong, and there may be a considerable drop in the recent high saving rate. As a result, the third quarter may still be relatively strong, and -- with induced inventory accumulation of consumer goods -- even the fourth quarter may show some real growth. Nevertheless, a gradual slowing of the expansion seems inevitable, not only as a result of the surtax, but also because of the leveling of Federal Government outlays described above, and slow growth in plant and equipment. Even the expected acceleration in housing starts probably will occur too late to have an appreciable impact on actual expenditures on residential construction before the year ends.

Again, from this review of the mainsprings of economic expansion during the current year, I conclude that the outlook is for a substantially slower -- not faster -- rate of growth in the closing months of 1968.

Moreover, I expect the slower pace to continue during the first half of 1969, unless there is amajor change in public expenditure policies which cannot be foreseen at this time. With respect to the private sector, the general contours of the new year seem to be already emerging. In January, the scheduled rise in social security taxes will drain about $3 billion of income from the private sector, split about evenly between employers and employees. The need for many wage and salary earners to make up a large share of the retroactive part of the surtax enacted last June will also be a dampener on disposable personal income during the early months of next year. Expenditures on residential construction should be rising, at a rapid pace, and businesses may be increasing their investment in inventories. Their outlays for plant and equipment may also be expanding somewhat in the first half of 1969.

Nevertheless, I am personally convinced that the 10 per cent income surtax, plus whatever moderation we do get in Federal Government expenditures, in combination with the policy of monetary restraint followed with varying degrees of stringency since last November -- will have a significant dampening effect on the rate of growth of output in the first half of next year. In fact, because of the delayed effects of monetary restraint, I personally think the monetary authorities must remain alert to see that the total amount of restraint exerted by our stabilization policies is not more than is necessary to bring about the slower rate of growth that I believe is definitely required.

I realize, of course, that it is impossible to specify just how much total restraint is "enough" -- or just what lower rate of growth would be appropriate. However, we should remind ourselves that, given the long-run trend of population and productivity in this country, we could ordinarily expect an annual rate of increase in real output in the neighborhood of 4 per cent. Thus, if we experience an increase at an annual rate well below that amount in the final six months of this year -- and if a rate of growth below the long-term trend is also registered in the first half of next year -- I would think personally that the economy would be performing in a way conducive to an easing in inflationary pressures.

If this slower growth rate unfolds as expected, its impact on price trends should also be helpful. It will be recalled that the GNP implicit deflator (perhaps the most broadly-based of the price indexes) rose at an annual rate of 3.7 per cent in the first quarter and by 4.0 per cent in the second quarter of this year. During the July-September months, the rise may considerably exceed 4 per cent at an annual rate, reflecting the pay increase for military and civilian employees of the Federal Government effective in July. But allowing for this factor, the deflator will probably rise about as rapidly in the current quarter as it did in the April-June period. However, in the closing three months of this year, the GNP deflator may rise somewhat more slowly.

While this outcome would suggest some easing in the rate of increase in prices, inflation would still be a central problem. Consequently, we would still need further moderation in the rate of economic expansion on into 1969. If we do get such a continued moderation, I also think that it would have a beneficial impact on prices. It may be recalled that during the second quarter of 1967 -- a period during which the pace of economic advance eased appreciably -- the GNP deflator rose at an annual rate of only 2.1 per cent. In the final quarter of 1966, this index rose at an annual rate of 3.5 per cent.

Having stressed the need to make headway in the campaign against inflation, I wish also to take note of the expected impact of a slower rate of growth on employment and unemployment. The expansion in nonfarm employment in the last half of 1968 may be quite small.

The unemployment rate, which averaged 3.6 per cent in the second quarter, may move up somewhat during the closing three months of 1968 -- as industrial production eases off and as the capacity utilization rate in manufacturing declines somewhat below the 84.5 per cent recorded in the second quarter. As we move through the early months of 1969, the unemployment rate may edge up somewhat further. Recognizing this possibility, however, I think we should be prepared to view it in the context of our efforts to cope with the inflationary pressures which have persisted for most of the last three years.

Against this background, I think the proper role for monetary policy is to help assure that the needed moderation in the expansion of economic activity is -- in fact -- moderate. While the policy stance should contribute to a slower rate of growth in the final months of this year, it should also remain flexible to assure that the slackening in output will not go too far in the early months of 1969. In the same vein, flexibility should not mean that conditions are brought about in the first half of next year which would provide stimulation for an excessive rate of expansion in aggregate demand after mid-year.

Monetary Policy and Debt Financing

The second major issue with which I believe the monetary authorities will have to cope in 1969 concerns the meshing of monetary policy with fiscal policy and the financing of the national debt. It will be recalled that during the fiscal year ending last June 30, the Federal Government ran a deficit of $25.4 billion, almost three times the $8.8 billion recorded in the preceding twelve months. To finance this deficit, borrowing by the Federal Government in the 1968 fiscal year amounted to $28.4 billion. Of this total, $10.8 billion were absorbed by Federal Reserve Banks and Government agencies and trust funds, leaving $17.6 billion to be financed in the money and capital markets. The bulk of this net market borrowing ($16 billion) was centered in the second half of 1967. Reflecting these circumstances, the publicly held Government debt (excluding that held by trust funds and Federal Reserve Banks) rose by $15.9 billion in the July-December months of 1967. In the January-June period of 1968, the publicly held debt rose by $1.0 billion, in contrast to a decline of $13.7 billion in the same months of 1967.

As is widely known, the impact of this Government financing on the money and capital markets was substantial. For example, in July, 1967, market yields on 3-month Treasury bills averaged 4.20 per cent; yields on 6-month bills averaged 4.72 per cent, and those on 3-to-5-year issues averaged 5.17 per cent. In June, 1968, market yields on these three types of Government securities averaged 5.52 per cent, 5.64 per cent and 5.71 per cent, respectively. While these sharp increases in yields on Government securities partly reflected the general market pressures generated by an expanded demand for funds by private borrowers during a period of monetary restraint, the magnitude of the Federal deficit which had to be financed was obviously a major cause as well.

Because of the passage of the surtax and a slowing in the rate of growth of Federal spending, the budget deficit in the fiscal year ending next June 30 may be in the neighborhood of $5 billion. Thus, net cash borrowing during the current fiscal year should be substantially less than in the previous twelve months. While it is impossible to forecast this volume, the publicly held debt may rise by less than $12 billion during the second half of calendar 1968. Moreover, the publicly held debt should decline considerably in the first half of calendar 1969, in contrast to the increase of $1.0 billion which occurred in the January-June months of this year.

However, the task of managing the Federal debt seems likely to pose less of a complication for monetary policy through mid-1969. The question after that will revolve around the status of the 10 per cent surtax which is scheduled to expire next June 30. While nothing specific can be said at this juncture about the budget for the fiscal year that will get underway next July 1, it is clear from recent comments by budget and other government officials that already existing programs will require a higher level of Federal spending. Exactly how much this rise may be cannot be determined with much precision. On the other hand, it is possible that some budget savings could result from cancellation or paring of other programs, but here, again, the results of such an effort must necessarily remain uncertain.

Consequently, if the Vietnam War continues through 1969, the expiration of the surtax as scheduled next June could well intensify the question of coordinating monetary policy with fiscal policy and the financing of the public debt at a time when general economic activity may also be quickening.

Monetary Policy and the Balance of Payments

It almost seems trite to stress that the continuing deficit in our balance of payments will be a major issue for monetary policy in 1969. Nevertheless, it is obvious that the deficit will still be with us as the new year begins. In my personal judgment, the continuation of the short-fall in our international accounts should have a major influence on the nature and content of monetary policy in the coming year. However, I do not believe that a monetary policy aimed at improvement in the balance of payments conflicts with a monetary policy aimed at the restoration of domestic stability. On the contrary, I think the two objectives are quite compatible and amenable to attainment through the same set of coordinated stabilization policies.

We might remind ourselves briefly of the magnitude of the task that confronts us. On the liquidity basis of accounting for our balance of payments, the deficit was at a seasonally adjusted annual rate of $2-1/2 billion in the first quarter. Considerable improvement occurred in the second quarter, when the deficit on the liquidity basis declined to a seasonally adjusted annual rate of about $700 million. Thus, compared with a payments deficit of $3.6 billion in 1967 as a whole, the improved performance during the first half of 1968 was obviously welcomed. However, it is also obvious that much of the improvement arose from developments that cannot be counted on indefinitely. So, we still have a serious balance of payments problem which will tax the energy and imagination of the monetary authorities -- along with others in Government and in our private economy -- during the coming year.

Monetary policy can make its greatest contribution to the strengthening of our payments position by helping to restore price stability at home. This in turn would be of immeasurable assistance in the rebuilding of our trade surplus through recovering much of the competitive ground our exports have lost in recent years. By helping to moderate the excessive rate of expansion in domestic output, monetary policy would indirectly serve as a dampening influence on the spectacular rise in imports that began in 1965.

The steady shrinkage in our trade surplus since 1964 is widely appreciated, but it might be helpful to remind ourselves of just how large the decline has been: in 1964, the surplus of merchandise exports over imports amounted to $6.7 billion; during the next three years, it dropped to $4.8 billion in 1965, to $3.7 billion in 1966, and to $3.5 billion in 1967. In the January-June months of this year, the trade surplus shrivelled to roughly $100 million. While a brighter performance is expected in the second half of 1968, for the year as a whole, our trade account must be viewed with anxiety. Again, the reason for this centers in the continued sharp advance in imports. In the second quarter of this year, imports -- at a seasonally adjusted annual rate -- were $6.8 billion higher than the level recorded in the same period last year. The corresponding year-to-year gain in exports was only $2.5 billion. Thus, while imports climbed by 28 per cent during these twelve months, the rise in exports was just over 8 per cent.

In a somewhat longer view, the spurt in imports is seen even more sharply. For example, the ratio of imports to GNP remained in the range of 2.84 per cent and 2.98 per cent during the years 1960-64. However, beginning in the next year, it has risen steadily: to 3.12 per cent in 1965, to 3.42 per cent in 1966, and to 3.40 per cent in 1967. Moreover, the rise in the ratio not only continued in 1968 -- but the jump was especially sharp, to 3.76 per cent in the first quarter and to 3.87 per cent in the second quarter.

Also in a somewhat longer view, the relative deterioration in the competitive position of our exports because of domestic inflation stands out in bold relief. For example, during the years 1960-65, consumer prices in the United States rose by an average of 1.3 per cent per year. This was much less than the average percentage rise in prices in those leading industrial countries which are our main competitors: Japan, 6.0; Italy, 4.9; France, 3.8; United Kingdom, 3.5; Germany 2.8; Canada 1.6. However, as inflation accelerated in this country, our relative price situation changed sharply. In the two years ending in 1967, the annual advance in consumer prices in the United States averaged 2.9 per cent, or more than double the rate of increase registered in the first half of the decade. But, with the exception of Canada, our principal competitors experienced a significant moderation in the percentage rise in consumer prices during the same two years: Japan, 4.6; Italy 2.8; France, 2.7; United Kingdom, 3.2; Germany, 2.5; Canada 3.7. Thus, it should be self-evident that our trade account needs all the assistance monetary policy can provide.

Perhaps fortuitously, while the trade account was deteriorating further this year, the balance of payments has benefited considerably by a striking rise in the inflow of foreign private capital. For instance, in 1967, there was a net outflow of $2.3 billion through private capital movements. But during the first six months of this year, such capital flows shifted to a surplus of over $1 billion. A principal element in this swing were the purchases by foreigners of stocks of U.S. firms. These purchases amounted to about $800 million in the first half, about equal to the total for all of 1967. While no one can predict whether this inflow will continue at anything close to the recent rate, the expanding role of American securities dealers in Europe (especially through their widening contacts with European institutional investors) suggests that the more active purchase of U.S. equities by foreign investors may not dry up rapidly.

With respect to direct investment abroad, the outflow of funds in the first half of 1968 was about $1.4 billion, slightly above the $1.3 billion recorded in the same period of 1967. However, allowing for the use of proceeds of foreign borrowing by U.S. corporations in both periods, there was probably an appreciable year-to-year decline in the outflow of funds for direct investment. Furthermore, as the mandatory restraints on direct investment announced on New Years Day take hold during the second half of 1968, the outflow for this purpose will probably be moderated even more sharply.

Undoubtedly, monetary policy during the current year has had its greatest direct impact on the balance of payments measured on the basis of official settlements with foreign central banks and governments. Essentially this measure excludes the movement of short-term funds owned by private foreigners. During the first quarter of this year, the official settlements deficit was $500 million, seasonally adjusted. In the second quarter there was a dramatic shift to a surplus of $1-1/2 billion.

This dramatic swing was brought about primarily by the inflow of funds through foreign branches of U.S. commercial banks. In the second quarter, total U.S. liquid liabilities to commercial banks abroad and to other private foreign holders rose by $2.2 billion. To a considerable extent, this enormous inflow of private short-term funds reflects the strong bidding for Eurodollars by the head offices of U.S. banks as a means of adjusting their reserve positions during a period of rising domestic interest rates and a slowing in the growth rate of time deposits -- especially a lessening in the availability of large denomination certificates of deposits (CD's). But it also reflects the sizable increase in the supply of Eurodollars generated by the shift out of sterling and the French franc in May and June as both those currencies came under severe pressure in the foreign exchange market.

While the inflow was most dramatic in the second quarter, commercial banks' liabilities to their foreign branches have risen considerably over the course of 1968 -- despite fluctuations from time-to-time as U.S. interest rates and the availability of CD's have varied. By the end of August, the liabilities of head offices to foreign branches were about $3-1/2 billion above the level at the end of 1967.

Obviously, I cannot predict the behavior of these inflows during the coming year. However, by their willingness to compete for Eurodollars through their foreign branches, American commercial banks have been instrumental this year in dampening the rate at which foreign official institutions accumulate claims against the official reserves of the United States. I am hopeful that U.S. commercial banks will continue to be helpful in this manner in the coming year.

In the meantime, I also have a special interest in those capital flows represented by foreign lending by American commercial banks. Since last June, on delegation from the Board of Governors, I have had responsibility for the management of the foreign credit restraint program relating to commercial banks. This year -- as has been true in each year since the special effort began in 1965 -- the banks reporting under this program have made a substantial contribution toward reducing the deficit in our balance of payments. It might be recalled that in 1964, foreign assets held by U.S. commercial banks rose by almost $2-1/2 billion. However, once the program was launched in early 1965, assets subject to restraint increased in that year by about $170 million, although the permitted increase under the ceiling then in effect was almost $500 million. In 1966, despite an increase in the ceiling, the bank's covered foreign assets fell by $160 million, leaving the banks almost at their December 31, 1964, position. During 1967, covered foreign assets expanded by $370 million, but the banks at the end of the year still had an aggregate leeway of $1.2 billion.

The program for 1968 requested that banks reduce their covered foreign assets by at least $400 million during the year. By June 30, the reduction had reached $650 million. During July, there was a further inflow of $130 million. Thus, in the first seven months, the banks already had reduced their foreign credits outstanding by almost $800 million, or twice the amount that had been requested for all of 1968. At the end of July, the banks were $410 million below the December, 1964, base figure, and they had an aggregate leeway as of July 31 of $800 million.

As we look ahead to 1969, I am personally convinced that the continuation of the foreign credit restraint program for commercial banks will be a vital necessity. However, the specific provisions of the program can be determined only by the Federal Reserve Board as a whole after consultation with other Government agencies closely involved in the balance of payments effort. But the maintenance of the program would greatly reinforce the contribution of general monetary policy instruments toward improving our international payments situation in the year ahead.

Concluding Remarks

From the above comments, it should be evident that I believe monetary policy has a vital role to play during the coming year. Over the next few months, the principle objective should be a moderation in the rate of economic growth that is sufficient to pave the way for a return to domestic price stability. I believe such a slower rate of expansion is definitely underway and will become increasingly evident as the fiscal restraints adopted at mid-year begin to weigh on personal incomes and consumer spending. In the early months of next year, the pace of expansion should be dampened further. Under these circumstances, we should make some headway in our efforts to check inflation in this country.

At the same time, monetary policy should remain flexible and ready to relax just enough to assure that the rate of growth of output is not moderated so much that unemployment is allowed to climb to an unacceptable level. Since views may differ as to what rate of unemployment would constitute an unacceptable level, I personally will not attempt to give a quantitative definition. Moreover, while I would not applaud an increase in unemployment as an ideal state of economic affairs, I also realize that the process of achieving price stability in this country will involve real costs which we must be prepared to bear.

Looking further into next year, it seems evident to me that stabilization policies will have to be guided by the degree of success that we may have achieved in cooling off inflation in the first half of next year. If, in fact, the degree of demand moderation actually accomplished by mid-year turns out to have been particularly successful in cutting our rate of price advance -- and in converting the outlook for price stability from a wistful hope to a reasonable prospect -- then policy should be able to turn toward promoting a steadier, noninflationary, and more sustainable pace of economic growth from that point on.

If, on the other hand, inflation should prove to be an especially tenacious problem to solve, then continued judicious moderation of the expansion of aggregate demand would certainly remain an appropriate objective. Let me hasten to say, however, that I am not suggesting that a sharper curtailment of demand will -- in fact -- be called for as 1969 progresses. Rather, there may be need for a longer maintenance of policies of moderation in order to assure that we regain the capacity for prosperous but noninflationary economic performance. In the absence of major shocks from outside developments which cannot now be predicted, I think our price performance holds the key to what to do on the fiscal side in the light of the scheduled mid-1969 expiration of the 10 per cent surtax. That, I submit, may well turn out to be the most important economic policy decision of 1969.