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THE ECONOMIC OUTLOOK AND MONETARY POLICY IN 1971

Remarks By

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By

Andrew F. Brimmer*

I am delighted to share my views on the conditions bearing on monetary policy in the current year. To provide a framework for such a discussion, it would be helpful to present a brief review of the record of money and credit flows in the recent past and to make an assessment of the general economic outlook as well.

Before taking up this task, however, I must make it clear at the outset that the views expressed here are my own. By long tradition, when members of the Federal Reserve Board address themselves to such matters in remarks such as these, they speak for themselves and not for their colleagues. Also by tradition, Board members and Federal Reserve Bank Presidents serving on the Federal Open Market Committee (FOMC) try to avoid making comments that might be interpreted as forecasting the future course of monetary policy. I believe that both traditions are well-founded, and I personally try to abide by them.

It is also well to remember that -- despite the numerous and diverse voices that might be heard urging a particular course for

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I am grateful to Mr. Frederick M. Struble and Miss Harriett Harper for assistance in the preparation of these remarks. In addition, Miss Mary Jane Harrington did some of the calculations to obtain part of the data on bank credit flows.

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monetary policy -- the responsibility for monetary management rests with two clearly defined and statutory bodies: the seven-member Federal Reserve Board and the 12-member Federal Open Market Committee (consisting of the seven Board members and five of the Reserve Bank Presidents). There is no need (nor is this the occasion) to dwell on the distribution of tasks between the two groups or on the way in which monetary policy is made. It is sufficient to recall that the Board meets several times each week, the FOMC meets every three or four weeks, and open market operations are engaged in virtually on a daily basis -- and monitored daily by the Board and the FOMC. Thus, there is continuous opportunity to formulate and execute monetary policy in a timely and flexible fashion.

I wanted to make these points because a great deal of confusion develops from time to time (and the present appears to be such a time) about the locus of responsibility for monetary policy. Again, it is the responsibility of the Federal Reserve System. Having made these points, I must go on to stress that monetary policy is a component of national economic policy and it must be conducted as part of an overall strategy for the achievement of economic growth with reasonable price stability. Expressed differently, the Federal Reserve, by Congressional action, is endowed with a significant degree of independence which must be exercised within the Federal Government and not apart from it. At the same time, I believe that it is incumbent on the Federal Reserve to weigh and assess alternative courses of national economic policy

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and to keep the consequences of the different choices in mind at all times.

Against this background, what appears to be the proper task of monetary management at the present juncture? To answer this question, we should consider the constraints which might limit the scope for monetary policy as well as the opportunities that might be open for monetary policy to contribute further to the stimulation of economic expansion. One factor to which I personally attach considerable weight is the serious deficit in our balance of payments. Another constraint is the persistence of strong inflationary pressures -- despite the existence of an unusually high rate of unemployment and a substantial backlog of excess plant capacity. On the other hand, the very existence of these unused resources creates an opportunity to employ monetary policy to help reduce the real cost to the economy which they represent. How to balance off these competing objectives is the basic question troubling economic policy makers.

In the rest of these comments, my own views with respect to the proper priorities among these objectives are spelled out fully. They can be summarized here:

- While the economy has been operating well below its potential for more than a year, we still have made little lasting progress in the campaign to check inflation. Thus, a good part of the task remains ahead of us.

- At the same time, the exceptionally high unemployment rate and the sizable backlog of excess capacity -- indications of the real costs of national policies adopted in the fight against inflation -- have led

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to a new scaling of priorities which assign more weight to the expansion of output and less weight to moderating the rise in prices.

- Under these complex circumstances, the task of monetary policy is obviously difficult. In my judgment, the moderate rate of growth of money and credit in the last year has already restored much of the economy's lost liquidity. I believe it has also helped to lay a foundation for the growth of real output at a pace about as rapid as can be safely encouraged without rekindling the inflationary pressures that are only now beginning to abate.

- Finally, the large and continuing deficit in our balance of payments should also be a cause of concern -- a point which monetary policy must also take into account.

- But, if further simulation proves to be needed, instead of pressing for even greater monetary ease, I think it is preferable to adopt fiscal measures to strengthen the propensity of consumers to spend and to encourage businesses to increase investment in fixed assets.

We can now turn to the main body of the analysis.

Credit Flows in 1970: An Overview

To a considerable extent, credit flows in 1970 returned to more traditional channels -- thus correcting a significant part of the distortion which resulted from the policy of severe monetary restraint followed the previous year. The policy of restraint itself, of course, was necessary as part of the national campaign to check inflation. Likewise, in 1970, the policy of moderate easing in credit conditions was part of the national effort to cushion the slowdown in the economy and thereby prevent a large decline in output and an excessive rise in unemployment. In both years, the pattern of credit flows was a by-product of concerted efforts to achieve national economic objectives.

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In 1970, according to preliminary figures from the flow of funds accounts prepared by the Board's staff, total funds raised by nonfinancial sectors amounted to $95.4 billion. (See Table 1, attached.) This was an increase of $5 billion (or 5 1/2 per cent) over the level raised in the previous year. However, when the borrowing activity of the Federal Government is set aside, there was a year-to-year decline of $11.4 billion -- a drop of 12 per cent -- in the volume of funds raised. In 1969, the Federal Government's net repayment of debt amounted to $3.7 billion; of this amount, $1.3 billion was indirect public debt issues, and $2.4 billion was in issues of Federal agencies included in the budget. In contrast, last year, the Federal Government was a net borrower -- in the amount of $12.7 billion. It raised $12.8 billion in direct debt while budget agencies made net repayments of $100 million.

Setting aside the capital market activities of the Federal Government, other nonfinancial sectors raised $82.7 billion in 1970, compared with $94.1 billion in the previous year. Among major sectors, only State and local governments and agricultural businesses increased the amount of funds obtained. In the case of farms, the rise was very modest -- by only $100 million to $3.3 billion. On the other hand, State and local governments raised $12.2 billion in 1970, an increase of $3.7 billion or 45 per cent, above the amount raised in 1969. Their share of the total advanced from 9 per cent to about 15 per cent. So last year, State and local units registered some progress toward making up the short-fall in borrowing which occurred during the period of credit stringency in 1969.

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The largest drop in volume of funds raised occurred among households. Last year, they obtained $21.3 billion, a decline of $10.9 billion or one-third from the proceeding year. While households accounted for one-third of total funds raised in 1969, their share declined to one-quarter in 1970. A substantial part of the reduced borrowing by households in 1970 centered in home mortgages ($12.7 billion vs. $15.7 billion) and consumer credit ($4.3 billion vs. $9.3 billion). Both of these types of borrowing in turn reflected the lower rate of spending on home construction and consumer durable goods.

Nonfinancial corporate businesses raised $37.9 billion in 1970, about $1.2 billion less than the amount raised in the previous year. But, because of the greater relative shrinkage in borrowing by non-financial sectors as a group, the share of corporate businesses rose slightly -- from 42 per cent to 46 per cent. In 1969, the corporate sector was the principal gainer in funds raised in both absolute and relative terms. In that year, their heavy borrowing was undertaken partly to finance a sizable expansion in current output and partly to finance a strong investment boom. Last year, both of these activities registered only modest gains, and net corporate borrowing responded accordingly.

In terms of the sources of funds supplied in 1970, the more traditional pattern was also substantially restored. In 1969, there was a sharp swing away from financial institutions and toward households and nonfinancial businesses as sources of funds. The reverse was true last year.

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As shown in Table 1, there was a modest expansion last year in funds supplied by the Federal Reserve System. The amount rose from $4.2 billion in 1969 to $5.2 billion in 1970. This represented a slight increase in the System's share of total funds supplied (from 4.7 per cent to 5.2 per cent). Here again it must be stressed that these figures represent net changes recorded in the flow of funds accounts, and they should not be interpreted as measures of the impact of monetary policy. The U.S. Government played a moderately enlarged role in the aggregate supply of funds last year -- raising its share from 3 per cent to about 5 per cent. Somewhat over half of the expansion was accounted for by credit agencies.

Among other sources, the most striking turnaround occurred at commercial banks. In 1970, these institutions supplied $31.1 billion (one-third of the total), compared with $12.2 billion (one-seventh of the total) the previous year. In 1969, the relative position of commercial banks shrank drastically from what it had been the year before. These institutions, which bore the brunt of monetary restraint, lost a sizable amount of time deposits in 1969, and their lending ability was constrained accordingly. In 1970, with a slowing in economic activity and the move of monetary policy toward moderate ease, they gained deposits (especially time accounts), and they increased greatly the volume of funds supplied. Private nonbank financial institutions (particularly savings and loan associations) also expanded somewhat the volume of funds supplied. Last year, the amount provided by S&L's came to

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$14.9 billion (16 per cent of the total), compared with $10.4 billion (12 per cent of the total) in 1969. Again, the much stronger performance of these institutions reflected the greatly enhanced flow of savings to them (as well as to mutual savings banks and other financial intermediaries).

In contrast to the expanded role of financial institutions, private domestic nonfinancial sources experienced a sharp decline in the volume of funds supplied. In 1969, these sources (businesses, households, and State and local governments) provided $39.5 billion and accounted for over two-fifths of the total funds supplied. In 1970, the amount of funds originating with them dropped to $7.5 billion and represented only 8 per cent of the total. The decrease was especially noticeable among both businesses and households. In both cases, the flows reflect a fundamental change in the attitudes of businesses and individuals with respect to the valuation of market securities as investment outlets. During 1969, a substantial part of the outflow of funds from commercial banks and savings institutions was channeled into market securities -- including highly attractive Federal agency issues and short-term commercial paper. During 1970, as market yields declined and investor sentiment deteriorated somewhat, particularly after mid-year, these flows were reversed, and nonfinancial businesses and individuals constituted much less hospitable outlets for market issues.

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Sources and Uses of Commercial Bank Funds

At this point, we might look somewhat more closely at the behavior of commercial banks. It is in the response of these institutions that one can trace most graphically the impact of monetary policy on credit flows. The figures in Table 2 can be used for this purpose.

The expanded role of commercial banks as a source of funds in 1970, discussed above, was made possible by a sizable increase in their resources. As measured by the net increase in their liabilities, these resources rose by nearly $40 billion last year, compared with $18 billion the year before. The rise in demand deposits was about the same in both years ($6.4 billion and $5.2 billion, respectively). However, the situation with respect to time deposits was dramatically different. As already mentioned, in 1969 commercial banks experienced a sizable attrition in time deposits -- amounting to nearly $10 billion. Actually, the decline in negotiable certificates of deposit in denominations of $100,000 and over (CD's) was about $12 1/2 billion; this was partly offset by an increase of nearly $ 3 billion in other types of time deposits. In 1970, the banks' time deposits jumped by $38 billion, of which $15 billion (two-fifths of the total rise) was accounted for by CD's. Again, the sharp swing in these deposit flows reflected the changing posture of monetary policy in both years. As market yields rose in 1969 above the ceilings set by the supervisory authorities on the maximum rates of interest which could be paid on time deposits, the banks lost funds. In 1970

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(and particularly after mid-year when the ceilings were suspended with respect to CD's with maturities of less than 90 days), interest rates offered by the banks were again competitive with market yields -- which were declining sharply -- and the banks gained funds.

The figures in Table 2 also show the principal uses the banks made of their enlarged resources last year. Their net acquisition of financial assets amounted to $42 billion in 1970 -- more than double the total for the preceding year. Moreover, an overwhelming proportion of their funds went into investments in 1970 rather than into loans. This was in marked contrast to the banks' behavior during the year before. In the latter period, the banks liquidated $9 1/2 billion of U.S. Government securities and switched the funds into loans. In fact, bank loans rose by approximately $27 billion in 1969. Of this amount, over $5 billion represented real estate mortgages, over $3 billion was consumer credit, and other loans (including loans to businesses) accounted for $18 billion. In 1970, there was only modest growth in bank loans, the net increase was in the neighborhood of $5 billion. But bank investments expanded by nearly $20 billion. Well over one-half of the rise ($11.2 billion) was in State and local government securities, and about two-fifths were in U.S. Government issues.

Finally, last year, the commercial banks employed a substantial portion of their enlarged resources to repay liabilities to their foreign branches. During 1969, these liabilities (mainly Euro-dollar borrowings) rose by $7 billion as U.S. banks sought actively for

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alternative resources to expand loans in the face of shrinking deposits. The rise in such borrowings accounted for nearly two-fifths of the net increase in the banks' liabilities in 1969. Subsequently, as domestic funds became more readily available last year (and at lower costs), a considerable proportion of these liabilities was unwound. During the course of the year, commercial banks reduced the liabilities to their foreign branches by $6 billion.

On the basis of the foregoing analysis, it is clear that commercial banks entered 1971 with a greatly enhanced capacity to meet a sizable share of the economy's financial needs as the year unfolds. In the last few months, their position has been strengthened even more by further easing in credit conditions. Again we shall return to this subject in the final section of these comments. In the meantime, it would be helpful to sketch the main features of the economic outlook for 1971.

The Economic Outlook: GNP Projections

Although the first quarter of 1971 is nearly over, it is still too early to have a definite view of economic prospects for the current year. Yet, the information that has become available in the last month or so seems to indicate that a boom in economic activity is not likely to be generated in the near future. The unfolding evidence also suggests that the performance of the economy in 1971 may not come up to some of the more optimistic expectations advanced at the beginning of the year.

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While it is still too early in the year to have a firm factual basis for an assessment of the economy's prospective performance, a bumper crop of forecasts has already been made available to the public. There is no need here to summarize these extensively or to examine them in detail. However, it would be helpful -- when we return to the discussion of monetary policy -- to have in mind a general outline of the expected level and pattern of economic activity in the current year -- as seen in the official Federal Government projection and in private forecasts. The noticeable divergence between these projections has been commented on quite widely. Nevertheless, the differences are important, and the implications for public policy are significant. Thus, it might be worth pausing at this point to compare the two sets of forecasts. The figures are shown in Table 3.

For this purpose, a number of private forecasts were reviewed, and from these a "consensus" forecast of GNP and selected components was developed. The official Federal Government's "target" forecast (prepared by the Council of Economic Advisers), along with a few key components that are said to be consistent with such a target, is shown. As a benchmark, the actual GNP estimates for 1970 are listed.

As indicated, the official projection of $1,065 billion for GNP in current dollars for 1971 is $15 billion above the consensus

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forecast of $1,050 billion[1]. In the official forecast, the year-to-year increase in GNP would amount to $88.5 billion, or 9 per cent. In the consensus forecast, the gain is projected at $73.5 billion, or 7 1/2 per cent.

Since the official forecast includes estimates for only a few components, it is not possible to say very much about the economic underpinnings on which the growth in GNP is expected to rest[2]. However, the broad estimates provided do spotlight a number of crucial differences in assumptions on the part of the Federal Government compared with most other economists about the probable behavior of major sectors of the economy during the current year.

Perhaps the most striking difference is the projected behavior of consumers. In the official forecast, personal consumption expenditures are estimated to rise by $58.3 billion to $675 billion; this is an increase of about 9 1/2 per cent -- a rate of expansion slightly faster than the projected rise in GNP as a whole. In the consensus forecast, consumer spending is projected at $665 billion, a rise of $48.3 billion -- or $10 billion smaller than in the official projection. This would represent a gain of 7.8 per cent. The stronger

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(1)In passing, I should mention that my own assessment of the economic outlook leads me to conclusions not essentially different from the consensus forecast.

(2) In this presentation, I see no need to enter the controversy over the "best" way to forecast GNP -- i.e., whether to project components separately and add them up to get the total or whether the total should be forecast independently of the components. But in passing, I would observe that -- for both analytical and policy determination purposes -- some insight into the expected behavior of the components is esstential. It should be noted that the Council supplied the estimates of components after the $1,065 billion GNP target was submitted in the Annual Report. The components add up to $1,067 billion, but this difference does not affect the basic analysis.

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performance by the household sector visualized in the official projection assumes that personal saving as a proportion of disposable personal income would decline from 7.3 per cent in 1970 to 6.9 per cent in 1971. Principal factors underlying the assumed decline in the saving rate include improving economic conditions and consumer confidence, and rising consumer assets and liquidity. Reflecting the higher level of residential construction and the after-effects of last year's automobile strike, consumer expenditures for furniture, household equipment, and automobiles are also assumed to exert downward pressure on the saving rate.

On closer examination, however, it becomes clear that the official projection -- although not stating it explicitly -- also assumes a much larger increase in personal income (both before and after taxes) than that projected in the consensus forecast. Otherwise, the official projection of a $58 billion rise in consumer expenditures cannot be sustained. Most estimates included in the consensus forecast put the rise in personal income in 1971 in the neighborhood of $55 billion, the rise in after-tax income at about $50 billion, the increase in consumer expenditures at $48 billion, and the decline in the saving rate to around 7 per cent. Since the saving rate is essentially the same in the official and consensus forecasts (6.9 per cent and 7 per cent, respectively), the much larger expansion in consumption outlays shown in the official projection presupposes either a much faster rise in personal income (perhaps on the order of $6-$8 billion) or greater relief in personal income taxes -- or

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some combination of both. It is well to keep this important point in mind when judging the reasonableness of the two sets of forecasts.

Another significant difference in assumptions leading to differences in the projections relates to expectations about the behavior of expenditures for residential construction. In the official forecast, such outlays are projected at $41 billion in 1970, compared with $29.7 billion last year. Thus, an increase of $11.3 billion (or nearly two-fifths) is assumed in the official estimate. In contrast, the consensus forecast suggested a rise of $9.3 billion -- to $39 billion (or an advance of less than one-third). The official estimate for residential construction expenditures assumes that housing starts will climb to about 2 million in 1971, compared with 1.43 million in 1970, an increase of about 40 per cent over last year. The central estimate in the consensus forecast puts housing starts in 1971 in the neighborhood of 1.9 million, an increase of roughly 33 per cent. The much stronger performance of the housing sector visualized in the official forecast -- 100,000 more starts and $2 billion in spending -- apparently can be traced (at least in part) to an expectation of stronger flows of funds to savings institutions and lower mortgage rates -- both of which in turn seem to presuppose a greater availability of credit than anticipated in the consensus forecast.

There is little difference between the two projections with respect to business fixed investment. Both expect such outlays to total about $106 billion in 1971, reflecting an increase of 3 1/2 to

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4 per cent from the previous year. With respect to investment in business inventories, however, the official forecast assumes a much more vigorous rise. In the official projection, the increase in such stocks is put at $8 billion, double that assumed in the consensus forecast. While both projections allow for some catch-up following the automobile strike last year, the official forecast also assumes a much more energetic expansion in the pace of economic expansion. This in turn would give an appreciable lift to the rate of inventory accumulation.

In the case of total government purchases, both projections are fairly close together. However, they diverge somewhat with respect to the expected behavior of the Federal vs. State and local governments. The official forecast assumes a slightly larger decrease in Federal spending -- and a somewhat larger increase in State and local spending -- than is assumed in the consensus forecast. The official estimate rests heavily on expectations of an extraordinary rise in Federal grants to State and local units as well as on the projected improvement of the economy and the concomitant increase in State and local tax revenues. In addition, the greater availability of credit assumed in the official projection is expected to provide extra stimulus to State and local spending for capital improvements. In passing, it should be pointed out that the official assumption of a sizable rise in Federal grants is made although the main source of the expansion -- revenue sharing, if enacted -- would not begin until the fourth quarter of the current calendar year.

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The above analysis of the two projections leads to the following conclusion: the official projection is much more optimistic than the consensus forecast, and the explanation of the difference is also clear. The official outlook visualizes powerful thrusts from consumer spending which would stimulate business inventories as well as outlays for residential construction. Underlying both is the critical assumption of a significant further easing in monetary conditions from the already easier conditions achieved through monetary policy operations by the beginning of this year.

Implications of the GNP Projections

The consequences of the divergent forecasts for real output, prices and unemployment are worth noting. Again, the official projections provide little information on expected developments with respect to these factors during 1971. Instead, the focus is on a longer run horizon -- mid-1972 -- and only the general direction of changes in prices, unemployment, and real output during the current year are indicated. It is stated that a $1,065 billion GNP in 1971 would assure satisfactory progress toward an unemployment rate in the 4 1/2 per cent zone and an inflation rate approaching the 3 per cent range by mid-1972. Given the assumed growth in GNP in 1971, real output would rise strongly, the unemployment rate would be substantially lower at the end of 1971 than it was at the close of 1970, and the rate of increase in prices would be declining through the year.

These qualitative expectations cannot be translated easily into quantitative estimates. However, by drawing on testimony and

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comments by Federal Government officials -- as well as by inferences derived from the official forecast -- one can sketch the broad contours of changes in output, unemployment, and prices consistent with the official GNP projection. These can then be compared with the changes implied by the consensus forecast.

The results of my own analysis suggest that the two sets of estimates, respectively, might be in the following zones: the rise in real output, 4 per cent vs. 2 3/4 per cent; the rate of unemployment, 5 1/2 vs. 6, and the rate of increase in prices, 5 per cent vs. 4 1/2 per cent. Even if these estimates are only approximately correct, they put into sharp focus the probable consequences of the alternative paths of economic performance implied by the two projections. If the official forecast actually should be achieved during 1971 -- a point which is by no means certain -- it would probably yield a larger gain in real output and a larger reduction in unemployment than would most likely occur if the consensus forecast were the outcome. On the other hand, very little progress would be likely in checking the rate of inflation. This is the dilemma which the framers of national economic policy -- and the country at large -- must face. We shall return to this issue in the closing section of these remarks.

The Impact of Monetary Policy

In the case of monetary policy, it is clear that the moderate expansion of bank reserves that has been underway for more than a year

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has already had a significant impact on money and credit flows. The evidence is summarized in Table 4. A number of conclusions are suggested by these figures, but several should be mentioned explicitly. In the first place, if one is to have a clear view of monetary trends, it is of crucial importance that one avoid being trapped into following any single statistical measure. This is particularly true if that measure happens to be the narrowly defined money supply (currency plus private demand deposits). As indicated in Table 4 -- so defined -- the money supply rose by about 5 1/2 per cent in 1970, compared with 3 per cent in 1969. During the first nine months of last year, the expansion was close to 6 per cent at an annual rate. However, in the fourth quarter, the annual rate dropped to 3 1/2 per cent, and it fell further to 1 per cent in January of this year. This behavior of the narrowly defined money supply led to a great deal of comment with a number of observers suggesting that monetary policy should be made significantly more stimulative.

I am personally gratified that the Federal Reserve did not follow that advice. Instead, the System adhered to a moderate pace of monetary growth. Simultaneously, it was pointed out that a considerable amount of liquidity had been created, and much of it was showing up in the form of time and savings deposits in commercial banks and savings institutions. In 1970, such deposits rose by 18 1/2 per cent, and at S&L's and mutual savings banks the rise was 8 per cent. In the final quarter of last year, the increases were

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at annual rates of 22 per cent and 12 per cent, respectively. For both groups, the annual rate of growth jumped to about 25 per cent in January.

Officials in the Federal Reserve also stressed that the spreading effects of the automobile strike last fall would have an adverse impact on the demand for money and credit. While this point appears obvious, it apparently was given little weight by many of those who have become fascinated by the behavior of the narrowly defined money supply -- and were thereby induced to urge that the Federal Reserve flood the economy with even more liquidity. By February, as the economy began to show the effects of the resumption of automobile production, it became even more evident that bank credit and money would expand along with the quickening of economic activity. In February, bank credit (as measured by the adjusted bank credit proxy) rose at an annual rate of 13 per cent and the narrowly defined money supply at an annual rate of 14 1/2 per cent. If January and February changes are combined, the growth rates of all of the monetary variables are higher than for 1970 as a whole, and some of them even exceed the noticeably rapid rates of expansion in the third quarter of last year.

The impact of sluggish economic conditions -- which were further depressed by last fall's automobile strike -- on the behavior of bank credit is also reflected in Table 5. As these figures show, total loans at commercial banks declined at an annual rate of 1 per cent during the fourth quarter but then a sharp turnaround occurred over the first two months of this year. A marked swing in business loan growth (from an annual rate of decline of 9 per cent to an annual rate of growth of 10 per cent) was mainly responsible for this shift in credit

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growth. In addition to the contrast in the strength of business conditions in the two periods, heavy repayment of bank loans out of the proceeds of capital market financing during the fourth quarter and a sharp let up in such repayments early this year was responsible for the differing rates of business loan growth.

From my examination of these trends in money and credit, I am convinced that the Federal Reserve has already gone a long way toward providing the reserves the economy will need to restore the liquidity lost during the period of monetary restraint in 1969. In fact, as I reflect on the enormous stock of short-term assets which banks, households, business firms, and other sectors have accumulated in the last year, I think we can -- and should -- consider whether enough liquidity has also been created to see the economy well on its way toward generating a considerable expansion in real output in the current year -- and this without rekindling the inflationary pressures which are only now subsiding.

Interest Rates, Capital Flows, and the Balance of Payments

My concern for avoiding an excessive growth of credit stems partly from the sharp fall that has already occurred in interest rates. While the decline has been most dramatic in short-term rates, long-term rates have also declined appreciably. Currently, yields on 3-month U.S. Treasury bills are in the neighborhood of 3.50 per cent. In contrast, during 1969, yields on these issues reached a high of 8 per cent. In 1970, the average was close to 6 1/2 per cent. The federal funds rate has also dropped to about 3.50 per cent -- from a

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high of 9.68 per cent in 1969 and an average of 7.17 per cent last year. The discount rate at the Federal Reserve Banks has been reduced from 6 per cent to 4 3/4 per cent since last November.

In the capital markets, yields on U.S. Government securities with a 10-year maturity have declined to 5 3/4 per cent. In 1969, interest rates on these issues climbed to a high of 7.84 per cent. Reflecting the continuing heavy volume of new issues, the decline in interest rates on corporate bonds has been somewhat smaller. For example, yields on new corporate issues rated Aaa declined from a high of 9.30 per cent in 1970 to 6.76 per cent during the last week of January. However, under the impact of a large volume of flotations, yields backed up sharply and climbed to 7.79 per cent in the first week of March. Subsequently, these rates eased off to a current level of about 7.54 per cent. Rates on residential mortgages (as measured by FNMA auction yields) have decreased from a high of 9.36 per cent in 1970 to about 7.43 per cent currently.

On balance, there might be an opportunity for some further decline in long-term rates, particularly if the stream of new flotations eases up somewhat. But, in the case of short-term rates, I personally think that the level of short-term yields may already have dropped so far -- and so rapidly -- as to stimulate an undesirable outflow of short-term capital from the United States.

To a considerable extent, as indicated above, this outflow has centered in the repayment by U.S. banks of Euro-dollars obtained primarily through their foreign branches. As shown in Table 5,

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total Euro-dollar borrowings rose by $8 1/2 billion in 1969. Last year, such borrowings shrank by $5.9 billion. However, three-quarters of this amount ($4 1/2 billion) was repaid in the second half of the year, when domestic interest rates declined sharply (both absolutely and relative to interest rates abroad), the costs to the banks of holding on to such funds became increasingly burdensome. For a number of banks, the potential advantage of maintaining a reserve-free base for Euro-dollar borrowings under Federal Reserve Board regulations continued to be appealing.

Yet, with the progressive decline of interest rates in this country, a growing number of banks decided they could no longer afford to pay the differential cost of funds (perhaps on the order of 1 percentage point), and a substantial amount of Euro-dollar liabilities was paid down. These liabilities (including borrowings from other institutions as well as from foreign branches) declined by $2 1/2 billion in the third quarter of 1970, by $2 billion in the fourth, and by another $2 billion in the first two months of this year. The liabilities of banks to their own foreign branches declined by $1 1/2 billion in the third quarter of 1970, and $3 1/2 billion in the fourth quarter. So far this year there appears to be no appreciable slowing from 1970's second-half rate of repayments, although the sales of $1.5 billion of special Export-Import Bank securities to foreign branches of U.S. banks has absorbed dollars which might well have ended up in the reserves of foreign central banks. As of March 17, outstanding liabilities to foreign branches amounted to about $4.8 billion, compared to $14 1/2 billion in January 1970 (the peak from which the current decline began). Even

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when the $1 1/2 billion of Ex-Im securities are included, the amount outstanding on March 17 ($6.3 billion) is less than one-half that of just over a year ago. At some point, however, one might expect a moderation in the pace of repayment of Euro-dollars -- despite the continued somewhat higher cost of maintaining the liabilities. The reason underlying this expectation is the need on the part of some of the head offices of U.S. banks to hold a certain amount of Euro-dollars as working balances and to facilitate the activities of their foreign branches.

What I find most troubling about these outflows of short-term capital is the fact that the funds end up in foreign central banks. When this happens, the result is a deepening of the deficit in the U.S. balance of payments, measured on the official settlements basis. In 1970, this deficit amounted to $10.7 billion, and the decline in liabilities to foreign commercial banks (including branches of U.S. institutions) accounted for three-fifths of the total. While central banks in a number of countries have demonstrated a willingness to hold a substantial amount of dollars in their international reserves, we can scarcely expect them to be other than reluctant to see a significant rise in such holdings. Neither can they be expected to refrain indefinitely from exchanging some of their dollar accumulations for other reserve assets (especially gold or SDR's).

I certainly would not like to over-emphasize the potential problems which could arise if short-term capital outflow from the United States continues at anything like the recent rate. Nevertheless, I doubt that anyone would argue that the international monetary

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system is strengthened by such flows. Instead, they undoubtedly make more difficult an already hampered adjustment process in trade and payments. They also contribute to undermining the efforts of a number of other industrial countries to bring their own inflations under control.

For these reasons, I believe that, in the conduct of monetary policy in the months ahead, the Federal Reserve should give close attention to the impact of its decisions on capital outflows.

Economic Policy for Stable Growth

Despite the constraints on monetary policy described above, I still believe the monetary authorities have a constructive role to play in our national efforts to spur a faster rate of economic growth. However, in my personal opinion, that role certainly does not require the Federal Reserve to swamp commercial banks and savings institutions with an unbridled flood of additonal liquidity. In fact, some observers have argued that the System may have already provided more reserves than the economy can use productively in the near term. I realize, of course, that judgments can -- and will -- differ on this point. However, the sharp decline in short-term interest rates and the greatly increased availability of credit certainly do suggest that the economy is not suffering from a shortage of money.

Instead, in my opinion, there is a serious shortage of effective demand. Neither businesses nor consumers appear willing to

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step up their rate of spending for goods and services -- which would in turn stimulate increased production, rising employment, and a decline in the backlog of unused plant capacity. Moreover, the sluggish propensity to spend on the part of consumers seems to reflect pessimistic expectations about future employment prospects and the likelihood of a foreseeable check to inflation. Businesses -- too -- seem to be suffering from a pessimistic view of the economic outlook. Caught in a severe profits squeeze and facing substantial excess plant capacity, they see little need for -- and little chance to benefit from -- a large increase in spending on new plant and equipment in the near term. In fact, given the weakness in consumer demand, many firms are still cutting back on the volume of current operations. This partly explains the moderate decline in the Federal Reserve Board's index of industrial production in February -- contrary to a general expectation of a further rise as the economy continued to rebound from last fall's automobile strike.

Under these circumstances, the situation may well call for direct measures to strengthen effective demand in the private economy. Since the major participants in the private sector (households and businesses) apparently are unwilling to provide the autonomous support required -- that is, by spending more and saving less out of a given income -- we may face a classic case that might call for action by the Federal Government. In my opinion, if that action should be

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required, it could take a variety of forms. However, a key requirement is that it work directly through the provision of inducements to consumers to spend and inducements to business firms to undertake fixed investment.

For this purpose, fiscal measures are clearly the most promising. There is no need to list an extensive catalog here, but a few examples recommended by others can be summarized to illustrate the essence of the point. Just this week, the Congress took two steps which should lend some support to consumer spending in the months ahead. It quickly passed a 10 per cent boost in Social Security payments and simultaneously postponed the rise in payroll taxes to finance them. The base for these taxes -- in earlier legislative plans -- was scheduled to be raised from $7,800 to $9,000 effective January, 1971. The change was delayed for a full year. The effect of this action should be a $1.4 billion gain in disposable personal income and a similar reduction in business costs. It has also been suggested that scheduled reductions in personal income taxes be accelerated. The personal exemption and the standard deduction are scheduled to increase at the beginning of next year, increases that were adopted as part of the tax reduction program in the Tax Reform Act of 1969. If both of these projected reductions were moved forward to this year, they might provide an additional boost of $2 1/2 billion to consumer's spendable income.

Still other efforts have been urged to strengthen the rate of fixed investment. While different surveys of investment intentions vary widely in their estimates of planned expenditures, most observes seem to expect the rate of increase to be in the neighborhood of

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3 1/2 per cent. Hence, there appears to be room to encourage a somewhat more vigorous effort. It will be recalled that a move has already been undertaken to liberalize depreciation guidelines for business equipment. This action will yield a stimulus of about $3 billion in 1970. Beyond this, Congress has been urged to restore the investment tax credit which was repealed nearly two years ago. At that time, some of us argued against the decision -- because we foresaw the long-run need to strengthen investment incentives. If the tax credit were restored, the short-run impact on after-tax profits and thus the flow of investible funds might be around $2 1/2 billion.

If further stimulation of the economy proves to be needed (which is not certain at this time), I urge that careful consideration be given to the fiscal approach -- rather than to the reliance on a still easier monetary policy. On the other hand, we must be extremely careful to insure that the steps we take and the instruments we use in the near term do not defeat our longer-run objective: the achievement of sustainable economic growth with a reasonable degree of price stability. Since inflation is far from checked, we must not provide the fuel for its rekindling before it has been effectively abated. I am personally convinced that the zone open to the Federal Reserve System within which to allow a further expansion of money and credit -- without adding to inflationary pressures -- is not very wide, and it is important that we stay within it.

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Table 1. Amount and Sources of Funds Raised in Capital Markets by Major Sectors, 1969 and 1970
(Amounts in billions of dollars)

Sector	1969 Amount	1969 Per cent of total	1970 Amount	1970 Per cent of total
Total funds raised by nonfinancial sectors	90.4	100.0	95.4	100.0
U. S. Government (1)	- 3.7	- 4.0	12.7	13.3
Public debt securities	- 1.3	- 1.4	12.8	13.4
Budget Agency issues	- 2.4	- 2.6	- 0.1	- 0.1
All other nonfinancial sectors	94.1	104.0	82.7	86.7
Distributuion among sectors	94.1	100.0	82.7	100.0
State and local governments	8.5	9.0	12.2	14.8
Households	32.2	34.2	21.3	25.8
Nonfinancial business	49.7	52.9	46.3	56.0
Corporate	39.1	41.6	37.9	45.8
Nonfarm noncorporate	7.4	7.9	5.1	6.2
Farm	3.2	3.4	3.3	4.0
Foreign	3.7	3.9	2.8	3.4
Sources of funds advanced	90.4	100.0	95.4	100.0
Federal Reserve System	4.2	4.7	5.0	5.2
U.S. Government	2.7	3.0	4.5	4.7
Direct	2.5	2.8	3.3	3.5
Credit agencies (net)	0.2	0.2	1.2	1.2
Funds advanced	9.0	9.9	8.8	9.2
Less funds raised in credit market	8.8	9.7	7.6	8.0
Commercial banks, net (2)	12.2	13.5	31.1	32.6
Funds advanced	16.5	18.3	29.3	30.7
Less funds raised in credit market	4.3	4.8	- 1.8	- 1.9
Private nonbank finance	30.4	33.7	37.3	39.1
Savings institutions, net	10.4	11.5	14.9	15.6
Insurance	21.8	24.2	23.3	24.4
Finance, N.E.C., net	- 1.8	- 2.0	- 0.9	- 0.9
Private domestic nonfinancial	39.5	43.7	7.5	7.9
Business	13.8	15.3	1.9	2.0
State and local gov't., gen.	6.1	6.7	- 2.7	- 2.8
Households	18.0	19.9	7.0	7.3
Less net security credit	- 1.6	- 1.8	- 1.2	- 1.3
Foreign	1.3	1.4	10.0	10.5

(1) Excludes sponsored credit agencies.

(2) Includes unconsolidated bank affiliates.

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Table 2. Sources and Uses of Funds by Commercial Banks, 1969 and 1970
(Amounts in billions of dollars)

Source or Use	1969 Amount	1969 Per cent of total	1970 Amount	1970 Per cent of total
Net acquisition of financial assets	19.7	100.0	41.9	100.0
Total bank credit	16.5	83.8	29.3	69.9
Credit market instruments	17.7	89.9	27.5	65.6
U.S. Gov't. securities	- 9.5	- 48.2	8.2	19.6
Direct	- 9.3	- 47.2	5.2	12.4
Agency issues	1.1	5.6	3.7	8.8
Loan participation certifs.	- 1.3	- 6.6	- 0.7	- 1.7
State and local obligations	0.4	2.0	11.2	26.7
Corporate bonds	- 0.1	- 0.5	0.5	1.2
Home mortgages	3.0	15.2	0.9	2.1
Other mortgages	2.3	11.7	1.0	2.4
Consumer credit	3.3	16.8	1.9	4.5
Bank loans, N.E.C.	17.8	90.4	0.6	1.4
Open market paper	0.5	2.5	3.2	7.6
Security credit	- 1.1	- 5.6	1.8	4.3
Loans to affiliate banks	0.6	3.0	- 0.1	- 0.2
Vault cash and member bank reserves	0.4	2.0	2.2	5.3
Miscellaneous assets	2.2	11.2	10.5	25.1
Net increase in liabilities	18.0	100.0	39.8	100.0
Demand deposits, net	5.2	28.9	6.4	16.1
U.S. Government	*	*	2.7	6.8
Other	5.2	28.9	3.7	9.3
Time deposits	- 9.7	- 53.9	38.0	95.5
Large negotiable CD's	- 12.6	- 70.0	15.2	38.2
Other	2.9	16.1	22.8	57.3
Federal Reserve float	0.1	0.6	0.7	1.8
Borrowing at Federal Reserve Banks	*	*	0.2	0.5
Loans from affiliates	0.6	3.3	- 0.1	- 0.3
Bank security issues	0.1	0.6	*	*
Commercial paper issues	4.2	23.3	- 1.9	- 4.8
Profit tax liabilities	0.1	0.6	0.1	0.3
Miscellaneous liabilities	17.4	96.7	- 3.7	- 9.3
Liabilities to foreign branches	7.0	38.9	- 6.1	- 15.3
Other	10.4	57.8	2.4	6.0
Discrepancy	0.3		- 0.1	
Current surplus	3.1		3.0	
Plant and equipment	1.0		1.1	

Note: Data show combined statement for commercial banks and affiliates.

* Not available

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Table 3

Projections of Gross National Product for 1971
(Amounts in billions of dollars)

Category	1970 (Actual)	1971 Forecast		Change: 1970 - 71			
				Amount		Percentage	
		Consensus	Official Adm.	Consensus	Official Adm.	Consensus	Official Adm.
Gross National Product	976.5	1050.0	1065.0	73.5	88.5	7.5	9.1
Personal Consumption Expenditures	616.7	665.0	675.0	48.3	58.3	7.8	9.4
Durable goods	89.4	97.0	n.a.	7.6	n.a.	8.5	n.a.
Nondurable goods	264.7	284.0	n.a.	19.3	n.a.	7.3	n.a.
Services	262.6	284.0	n.a.	21.4	n.a.	8.1	n.a.
Gross Private Domestic Investment	135.7	149.5	155.0	13.8	19.3	10.2	14.2
Business fixed investment	102.5	106.5	106.0	4.0	3.5	3.9	3.4
Residential construction	29.7	39.0	41.0	9.3	11.3	31.3	38.0
Change in business inventories	3.5	4.0	8.0	0.5	4.5	14.3	128.0
Net Exports	3.6	3.5	4.0	- 0.1	0.4	- 2.8	11.2
Government Purchases	220.5	232.0	233.0	11.5	12.5	5.2	5.7
Federal	99.7	98.5	98.0	- 1.2	- 1.7	- 1.2	- 1.7
Defense	76.6	73.5	n.a.	- 3.1	n.a.	- 4.0	n.a.
Other	23.1	25.0	n.a.	1.9	n.a.	8.2	n.a.
State and local	120.9	133.5	135.0	12.6	14.1	10.4	11.7

n.a. Not Available.

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Table 4.

Trends in Selected Monetary Variables, 1969, 1970 and January-February, 1971
(Per cent, annual rates of change)

	Annual		Quarterly and Monthly						
	1969	1970	1st Q. 1970	2nd Q. 1970	3rd Q. 1970	4th Q. 1970	Jan. 1971	Feb. 1971	Dec.'70 Feb.'71
1. Total reserves	-1.6	6.4	-2.9	2.6	19.1	6.6	12.2	11.1	11.7
2. Nonborrowed reserves	-3.0	9.5	-0.4	4.1	24.4	9.4	8.8	14.9	11.9
3. Currency plus private demand deposits	3.1	5.4	5.9	5.8	6.1	3.4	1.1	14.5	7.8
4. Commercial bank time and savings deposits	-5.0	18.4	1.4	14.1	32.2	21.8	25.5	28.6	27.3
a. large CD's	-53.3	132.4	9.5	61.8	256.2	79.4	50.9	12.4	31.9
b. other time and savings	1.4	11.5	0.9	11.3	16.5	15.4	22.3	30.5	26.7
5. Savings deposits at mutual savings banks and S&L's	3.4	7.8	2.5	7.0	9.3	11.5	25.3	13.4	19.5
6. Adjusted bank credit proxy	n.a.	8.3	0.5	6.5	17.2	8.3	10.5	13.3	12.0
Concepts of Money									
7. M_1: (3)	3.1	5.4	5.9	5.8	6.1	3.4	1.1	14.5	7.8
8. M_2: (3) + (4b)	2.4	8.2	3.4	8.4	11.0	9.2	11.5	22.4	17.0
9. M_3: (3) + (4b) + (5)	2.8	7.9	2.7	7.9	10.3	9.7	14.2	21.5	18.0

n.a. Not available.

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Table 5. **Changes in Bank Credit and Related Measures, 1969, 1970 and January-February, 1971**

	1969	1970					1971
	Year	Year	First Half	Second Half	Third Qtr.	Fourth Qtr.	First 2 months
		(Seasonally adjusted annual rate)					(per cent)
Total bank credit 1/	4.0	7.4	4.5	10.1	13.9	6.1	15.2
U.S. Government securities	-15.7	11.8	8.5	14.4	25.9	2.8	16.5
Other securities	---	20.1	10.4	28.3	20.3	34.5	29.4
Loans 1/	9.9	3.4	2.4	4.4	9.8	-1.0	10.9
Business loans 1/	13.1	2.1	8.1	-3.7	1.8	-9.2	9.7
			In billions of dollars				
Euro-dollar borrowing (including from other than branches)	8.5	-5.9	-1.4	-4.5	-2.5	-2.0	-2.1
Bank-related commercial paper	4.3	-1.9	3.3	-5.3	-3.0	-2.3	-0.4

1/ Adjusted for transfers of loans between banks and their affiliates.

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