For Release on Delivery
Approximately 2 P.M., E.S.T.
December 2 , 1969

U. S. MONETARY POLICY AND FINANCIAL MARKETS

Remarks of

SHERMAN J. MAISEL

Member
Board of Governors
of the
Federal Reserve System

at the

First Annual European
Institutional Investor Conference

London, England

December 2, 1969

U. S. MONETARY POLICY AND FINANCIAL MARKETS

A succinct summary of U.S. economic conditions is the statement that a majority of U.S. economists would give slight odds that the longest period of expansion in U.S. history (starting February 1961) has ended or is about to end. A similar majority would probably give equivalent odds that the contraction would not last long.

Such a statement is not too useful for you gentlemen who are responsible for institutional investments because these are estimates of a single possible GNP outcome with no indication of how wide the range of probable outcomes is. This problem of estimating the range or variance of possible events is typical of the difficulties you face in formulating strategies to find profitable and safe employment for the funds in your custody. With such problems in mind, I want briefly to discuss three related topics:

1. The major unknowns in the standard estimates of next year's growth.

2. The U.S. market as a method of minimizing risks.

3. More flexible exchange rates to minimize risks.

The Current State of the U.S. Economy

Since the fall of 1967, the basic policy of the U.S. Government has been to retard the growth rate of demand below that of supply in order to reduce pressure on prices and the balance of payments. Problems arose in getting the program under way, in determining the share of this deflationary pressure to be borne by monetary and fiscal policy, and in short-period timing, where difficulties have occurred; but, on the whole, the policy has succeeded. The growth rate for both current dollar and real demand reached a peak in the second quarter of 1968. Since then, growth has slackened considerably and progressively.

For 1969, real growth has been under 3 per cent--slightly below projections. Currently, the operating rate of the U.S. economy is not above 100 per cent of capacity for the first time since the acceleration of the Vietnam War in 1965. A majority of economists believe that actions already taken mean that demand pressures will, over the next several quarters, continue to slacken thus creating favorable implications for prices and the foreign trade balance.

What are the major forces which could cause these forecasts to be wrong?

... Fiscal policy: While the Administration is fighting to maintain a budget surplus, military expenditures, changes in tax schedules, and non-military expenditures remain subject to unexpected shocks and to further decisions. The future appears favorable, but deterioration is a possibility.

... Business investment: Expenditures on plant, equipment, and inventories have all been higher than would be expected from past experience. This has been attributed to highly optimistic forecasts of long-run sales and highly pessimistic forecasts of costs. The standard projections call for a comparatively high level of investment. If rates fell to normal, demand would be far less. If, contrary to most estimates, business investment rose still faster, the result would be inflationary.

... Consumption has been and is expected to remain moderate. On the other hand, important shifts in either direction are possible and have occurred at past turning points in the economy.

... Price and wage decisions form the most uncertain sphere. Believers in strong cost-pushes think that the expected level of surplus resources is insufficient to slow the rate of price-wage increases by much. Those who stress demand and money believe the expected surpluses will brake price rises rather quickly and will be followed by a slowing in wage increases.

How would these various possibilities affect monetary policy and interest rates? Frankly, I don't know. For the past six months, virtually all monetary and credit variables--and particularly those most strongly influenced by the Federal Reserve--showed either the lowest rate of growth or the maximum rate of contraction in recent history. For most of this period, of course, interest rates were also at record levels.

If demand for goods and services falls, this should cause a parallel fall in the demand for credit. On the other hand, the amount of liquidity in our financial system is extremely low. Any credit not demanded because of slower growth might be used to rebuild liquidity or it might be borrowed by those now rationed out of the market. Thus, most people would not expect the fulfillment of the standard forecast to cause any sharp variations in monetary conditions per se.

Of course, if all eventualities came out the other way, demand for credit would grow still stronger. Limits would be set only by disorderly conditions appearing in some major financial markets.

Some possibilities for sharp shifts in this sphere do exist, of course. Expectations might shift rapidly either because of new estimates of price movements, new liquidity desires, or a rush of speculative purchases or sales of credit instruments. Movements based on each of these factors have occurred in the past. At times the Federal Reserve has attempted to offset some of the impact of expectational changes. At other times, it has not. It has been widely criticized both for acting and for failing to act in such circumstances. I don't believe anyone (and I specifically include myself) can now predict with assurance how the Fed is likely to react under similar circumstances this coming year.

Developments in Offshore Dollar Markets

One sphere in which these credit developments may be expected to react with a heightened intensity is the Euro-dollar market in London. In recent years, the Euro-dollar market has been increasingly important as a marginal source of adjustment for U.S. banks. This has meant that movements in U.S. credit markets have tended to be magnified in it with respect to both rates and flows.

The offshore markets in dollar-denominated financial instruments--which have grown so rapidly over the past 10 years--have acted as a mechanism with disturbing effects on domestic economic conditions on both sides of the Atlantic. In Europe, you have watched the costs of local credits advance along with Euro-dollar deposit rates. On our side, these dollar balances have cushioned the effects of domestic stringency on the loan expansion of those U.S. banks with foreign branches. These developments suggest that, with further growth, these international credit markets, which are outside the normal administrative and legal authority of the central banks in the industrial countries, will pose critical problems for financial management in the future.

But I will not pursue this theme. Let me, instead, suggest that these offshore dollar markets are reinforcing the already substantial impact of the United States on the world economy. The movement abroad of U.S. corporations into manufacturing activities has been followed by the establishment of branches of U.S. financial institutions. The use of offshore dollar markets for financing U.S. corporate activity abroad and for providing funds for U.S. banks for head office use has been part of an unprecedented world-wide use of dollars by private parties outside the United States.

Long-Term Uncertainties and the Institutional Investor

Your responsibilities to find profitable and safe employment for the funds in your custody require continuous reconsideration of investment strategies in a rapidly changing world financial environment. Without doubt you are preoccupied--as are those of us concerned with day-to-day decisions of credit policy--with current short-term economic projections. But where your responsibilities are long term, you cannot avoid making an assessment of longer term trends. These may be hard to predict, but they are even harder to disregard. The subject matter of this Conference, I would suggest, indicates a growing awareness of this need to bring up to date the basic investment concepts from which daily portfolio decisions must be made.

The institutional investor recognizes that he must accept uncertainties as unavoidable. Therefore, he attempts to develop an investment strategy which seeks, over the long term, a maximum return consistent with safety. These long-term considerations lead me to suggest that the risk-averting investor can find in U.S. financial markets facilities which are unrivaled elsewhere.

Consider, for example, the risks from fluctuations in business activity you assume when you buy a long-term security. Fluctuations in U.S. economic activity are likely to be far less severe than those of other individual countries. This occurs simply because of the size of the U.S. economy and its share of world trade. While slack demand in the United States is bound to weaken activity in the economies of our trading partners, a recession elsewhere need not produce slack in the U.S. Accordingly, a portfolio of U.S. securities should experience what all investors seek--a smaller variance in this crucial area of risk.

Because of its limited foreign trade sector, the U.S. economy also offers protection against those adverse international developments which can threaten trading nations heavily dependent on export sales or on foreign supplies. Such economic vulnerability can also be accompanied by a political vulnerability which can have substantial economic effects, as the Russian invasion of Czechoslovakia and internal disturbances in France demonstrated in 1968.

Over the long term, the United States can also offer unparalleled growth incentives to the investor. Our economy, as you know, is not product-oriented but profit-oriented: with us, the word--"profits"-- can be used in mixed company! Incentives to individual and to corporate performance encourage American corporations to utilize--for economic growth--a superior research and development capability, a reservoir of labor skills, and the substantial natural resources within our boundaries.

Flexibility of U.S. financial markets. But an investment strategy must also place a premium on flexibility because economic and technological developments may make portfolio adjustments desirable. Our markets are neither thin, as in some countries, nor highly volatile, as in others. On the contrary, they are distinguished by depth, breadth, and resilience: as you know, blocks of up to a million shares of one particular corporate stock have been absorbed without significant price disturbance in New York markets within a single trading day. Opportunities for diversification are also unparalleled: you can choose a portfolio balanced to offset cyclical fluctuations in corporate earnings; or diversified among a number of advanced technology or growth industries; or structured to meet any other objective you choose.

U.S. markets have broadened as the average investor has responded to the quantity and, more important, the quality of information on corporate performance which is available to the "outsider." A tradition of public disclosure of corporate affairs, combined with experienced government surveillance of the activities of security dealers and corporations, have reduced the cost and improved the quality of information.

American management resources. Consider another area of uncertainty confronting the institutional investor. When you purchase a security, you are buying plant and equipment and a range of products; but you are also buying management. The management resources available to U.S. corporations constitute a major advantage in international competition. The family firm, which until recently was so significant in Europe's industrial structure, and the enterprise dependent upon a single outstanding executive talent are not common in the U.S. The mobility of key officials in American corporations is great: they sometimes resemble interchangeable parts as executives move, within the corporation, from one function or division to another or, outside, from one corporation to another, often in a different industrial sector. This wealth of trained executives, supported by an even broader dispersion of skills among middle management personnel, constitutes a major element in the "American challenge" which has attracted so much attention on this side of the Atlantic.

Exchange Rates and Long-Term Choices

Portfolio decisions must also consider long-term prospects for exchange rates among currencies. The past 10 years, which have been marked by an unprecedented expansion in international capital flows, have also been marked by a rigidity of exchange rates which is now recognized as unsustainable over the long run. It is increasingly evident that a country which achieves a 2 per cent per annum average increase in prices over an extended period cannot be linked by a rigid exchange rate to trading partners which have tolerated a yearly average rate of price increase of, say, 4 per cent.

Because of this unavoidable fact, financial specialists and government officials have been more willing to accept the view that exchange rate practices would have to become more flexible in the future than they have been in the past 10 years. Events since mid-1967 confirm this changed outlook: the devaluation of sterling in November 1967, of the French franc last August, and the temporary period of floating and subsequent appreciation of the DM in October illustrate these changes in attitude.

Proposals for wider bands, crawling pegs, upward crawling pegs, and sliding or gliding parities are now widely discussed in professional financial circles. As suggested by the Chancellor of the Exchequer, by the U.S. Secretary of the Treasury, and by others at the recent annual meeting of the International Monetary Fund, studies are about to get under way at the Fund to assess the technical and policy problems posed by them.

If more flexible rates result, these should serve to reduce the risks of international investments. Contrary to the worries of some, they should remove exchange rate risks from the area of feared major catastrophic events into the sphere of normal business risks. As a result, international portfolios should be more desirable than under a system which depends for adjustment on periodic large-scale movements in exchange rates.

In my view, the period from 1958 to 1967 was characterized by serious exchange rate risks although there were only a few changes in parities of major trading currencies. Could entrepreneurs and investors, as they made long-term commitments of their corporations' or their depositors' resources, really ignore the notorious series of currency crises, especially since 1964? Even more disturbing, though certainly less dramatic, were the trends toward controls and protectionism--the recourse by country after country to limit either the export or the import of private funds, the scattered use of restrictions on trade and other current transactions, and the use by the Common Market countries of changes in border taxes (as a substitute for exchange rate change) specifically designed to alter the foreign prices of their own exports and the European selling prices of imported goods.

Furthermore, changes in exchange rate practices and policies which would reduce the protracted surpluses and deficits experienced by the major industrial countries between 1958 and 1969 can only reduce risks in the long-term placement of funds abroad. The institutional investor should benefit in several ways. If occasional large and disorderly devaluations are replaced by more frequent but smaller changes in par values either up or down, his risk of substantial capital loss is less. Let me illustrate this point. A 25 per cent probability of a 10 per cent devaluation of a currency over a three-month period would require a risk premium of 10 per cent at an annual rate; but a 50 per cent probability of a 2 per cent devaluation over the same period would require only 4 per cent for the exchange risk element. What's more, if flexibility increases the chances for revaluations, the risks of loss from a portfolio diversified among currencies would be still further reduced. In a world of better balance in international payments, the investor would also find reduced the risks that controls would be used to circumscribe investment decisions and, even more serious, to reduce the flows of goods and capital among nations.

With experience of a limited flexibility in exchange rate practice, the institutional investor could greatly reduce his concern with exchange rate problems. In these circumstances, exchange rate uncertainties could be regarded as a less critical factor in portfolio decisions. In this sphere the risks and his efforts would be merely of the same order of magnitude, or even less, than the risks we normally take without question on prospective interest rate or income fluctuations. Such changes in exchange rate practices, as they proceed, are bound to encourage international portfolio diversification.

Conclusion

In reviewing my previous statements, I found I sounded much more like a salesman than an economist. Since this tone crept into my speech unknowingly and was not my objective, I went back to see why this was so and whether I ought to do anything about it. Upon review, I found that the case for U.S. investments as a way to minimize risks was far stronger than I had realized and that I had at least convinced myself. Let me, therefore, briefly summarize the points I have made.

First, we have, thanks to the size of our economy, a large and protected base to shield us from adverse developments in other countries, or in the state of international trade and finance in general. Secondly, the U.S. economy has extraordinary depth and breadth in the two critical areas of management and capital markets. Corporations can draw from a deep reservoir of managerial talent to fill almost any position; investors may take substantial positions in companies knowing that they will not be "locked in" due to inadequate trading markets. Third, the quantity and quality of information about American corporations far exceeds that obtainable in most other countries, rendering intelligent investment decisions far easier to arrive at. Fourth, with the development of a more realistic attitude toward rigid exchange rates, investment across international borders may be in the process of becoming more attractive. And finally, on a more short-term note, the increasing evidence of the long-sought moderation in the U.S. economy attests to the determination of U.S. authorities to pursue responsible economic policies.