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Recent Economic Expansion, Monetary Policy and Credit Markets

Remarks of George W. Mitchell

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at the

Graduate School of Banking

University of Wisconsin

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Recent Economic Expansion, Monetary Policy and Credit Markets

The curriculum here at the Graduate School of Banking quite properly emphasizes an understanding of the role of monetary policy. This is important not only because monetary policy is important but also because the nature of monetary policy is so little understood by the general public. As a banker, the people in your community may expect you to explain the reason for changes in monetary policy and the effects of these changes. As bankers, you and your associates note actions by the Federal Reserve are often associated with changes in the yields of your portfolio and the market value of your investments. But the precise way in which monetary policy works and the evidence for evaluating its adequacy or inadequacy is far from clear.

You, as bankers, are aware that changes in monetary policy rely on your profit-making propensities as well as those of other businessmen in order to affect the real economy. It is the very essence of monetary policy that it performs its function by creating changes in the money and credit climate that induce bankers, businessmen, investors and consumers to expand, contract, or continue with little change their scale of operations.

My intention today is to appraise the behavior of the real economy in the past 18 months, to try to evaluate the contribution made by monetary policy to economic expansion.

Profile of Recovery and Expansion

Gross national product reached its recent recession low in the first quarter of 1961. At that point, 6.8 per cent of the labor force was unemployed; only 77 per cent of our industrial capacity was being utilized; and gross national product, at $500 billion, was about $50 billion below what it would then have had to be for a satisfactorily low rate of unemployment. In the five quarters since, GNP has expanded at an annual rate of almost 7 per cent, after allowing for price changes. Growth was fastest, however, in the last three quarters of 1961--9.1 per cent. The annual rate of growth in 1962 has been only 3.3 per cent. And gross national product in the second quarter of this year at an estimated $550 billion remains about $30 billion below its current potential.

The 1958-59 period of recovery and expansion started from somewhat lower levels of capacity utilization than did the current one, but the gradient of expansion was more nearly sustained. GNP continued to grow rapidly through the first five quarters after the trough reached in the first quarter of 1958. As a matter of fact the rate of expansion accelerated in the first half of 1959. This is partly explained, however, by the inventory build-up preceding the steel strike that occurred in the summer of that year. Industrial production declined in the summer of 1959 because of the steel strike, but even so it was higher in that period as compared with its recession low than is the case now. (Chart 1).

The hesitant course of recovery during the first half of 1962 was accompanied by failure of unemployment to decline below 5.5 per cent of the labor force, whereas it had reached a 5 per cent rate by mid-1959.

Existing industrial plant capacity, however, was utilized in the first half of this year at a rate little different from the first half of 1959, when capacity utilization averaged 85 per cent. (Chart 2). In earlier expansionary periods capacity use at the same stage had been somewhat higher.

The rate of expansion in business spending for plant and equipment and for inventories, which was fairly rapid in 1961, slowed in early 1962. Plant and equipment spending picked up in the second quarter, but inventory investment dropped sharply after the steel settlement. Thus a part of the recent weakness in the economy is explained by the impact of some build-up of inventories in anticipation of a possible steel strike and a use of these stocks when it became apparent that there would be no strike. Meanwhile, residential building activity and consumer outlays for durable goods declined early in the year and rose in the spring although to levels only somewhat above late 1961. (Chart 3).

A slowing of growth in Federal Government spending has also contributed to the very moderate expansion of activity in recent months. Federal purchases of goods and services showed only a small further rise in the second quarter and new commitments for defense spending have been declining. Meanwhile State and local government outlays have continued the steady growth characteristic of the postwar period. (Chart 4).

In the meantime, average prices for goods and services have not generally risen. Periods of cyclical expansion have typically been accompanied by a tendency for average prices to rise. But since early 1958 average wholesale prices have been quite stable. Moreover, cyclically sensitive prices of industrial materials have shown little or no tendency to rise for the past year, whereas in the past they have risen in expansionary periods and declined during contractions. The rise in these sensitive prices has in the past provided an impetus to expansion of profits and an incentive to business spending. (Chart 5).

The current situation, therefore, is notable for the absence so far of upward price pressures. So far as average prices are concerned, this is explained in part by the level of unutilized resources and by a number of comparatively noninflationary wage settlements. So far as sensitive industrial prices are concerned, it may be explained more by moderate demand for basic materials relative to the domestic and world-wide capacity to provide them.

All in all, then, in the first half of 1962, spending, particularly for durable goods and inventories, slowed down. In relation to their incomes, both consumers and businesses spent less for final goods and services in the first half of 1962 than they had after a comparable period of time in the upswing following the cyclical trough of early 1958. (Chart 6). With consumer spending not very high relative to income and with the internal flow of business funds from retained earnings and depreciation larger than capital outlays, there have not been heavy demand pressures on credit markets and the supply of funds to markets has remained fairly large.

What can be said about the basic cause of this slowdown? Does it reflect fundamental shifts in the structure of the economy, or is it the same kind of cyclical phenomenon we have often experienced in the past?

It is too early, of course, to speak with any confidence on such matters. But let me point to a few relevant considerations.

In the past year or more, the public seems to have been quite willing to save. This could be the result of many influences, including diminished inflationary expectations. Saving is the source of funds to finance investment demand of business and consumers, but if investment demand is lagging, then the saving acts as a brake on economic growth.

It now appears that as the post-World War II experience recedes further into the past, we can count less and less on the willingness of the American consumer to go heavily into debt in order to acquire durable goods. Needs are less urgent and tastes are turning more toward services and types of expenditures less likely to be financed by borrowing.

At the same time, we find that the Federal budget moves rapidly, sometimes too rapidly, from deficit toward surplus in economic recovery. At such times enlarged Government saving supplements private saving. This places a heavy burden on rising investment outlays by business and consumers to maintain the momentum of economic expansion. To deal with structural problems such as these, monetary policy needs to be complemented by other governmental economic action.

Balance of Payments

Before discussing credit and monetary developments related to the recent slowdown in the rate of growth in economic activity, I would like, first, to touch briefly on the balance of payments situation. As you know, for several years now, foreign countries have been adding to gold and dollar holdings because they have been running a surplus in their balance of payments with the United States. Our trade balance has generally been favorable, but this has often been offset by aid and military expenditures abroad, by other current account payments for services, and by long-term capital outflows, in large part representing direct investments in overseas branches and subsidiaries. Taking all these elements together, then, we can see that what may be called our basic balance has been generally unfavorable in recent years. (Chart 7).

In 1960 and 1961, this situation was intensified by large short-term capital outflows from this country, partly because interest rates were high abroad and relatively low here, partly because of the demand for bank credit by certain foreign borrowers, and partly at times because of speculative activity in exchange markets. Such outflows have been less of a problem so far in 1962, however.

The balance of payments position has influenced credit market developments because monetary and fiscal authorities have attempted to minimize incentives for capital to flow abroad, particularly highly volatile liquid funds. It has had an influence primarily on short-term interest rates and, to some degree, on the availability of credit at commercial banks. Thus, financial market developments have been influenced not only by trends in domestic economic activity but also by balance of payments developments and by the reaction of policy authorities to such developments.

Supply of Funds to Markets

The continued high level of saving by consumers and business, which I touched upon earlier, has been accompanied by a shift in the supply of funds more toward the long end of the credit market. The supply of funds channeled to this sector of the market by commercial banks and nonbank financial institutions expanded during the first six months of 1962. This was partly a result of shifts in the structure of institutional liabilities, especially in the first quarter of the year, when the public channeled unusually large amounts of funds into time and savings deposits at commercial banks. I would first like to sketch some of these changes that occurred in supply conditions before discussing how they, together with changes in demand, became reflected in variations during the past several months in the cost of credit--that is, in interest rates.

Bank reserve positions. Reserves available to banks provide a basis for bank credit expansion and, therefore, an important influence on the supply of funds in markets. The reserve position of banks has continued to be comparatively favorable so far in 1962, although growth in their total reserves has been slower than last year. Member bank borrowings from Federal Reserve Banks have generally continued to be minimal. And free reserves of banks--that is, excess reserves less borrowings--have varied between $350 and $550 million for the past six months. In earlier expansionary periods, such as 1958-59, banks had already increased their borrowings markedly by this point, and they had shifted to a net borrowed reserve position. (Chart 8). The maintenance of a free reserve position for so long a period is primarily the result of moderate bank loan demand, and the consequent willingness of the Federal Reserve to supply reserves in step with total bank deposit expansion.

Excess reserves are held mainly by country banks and in the past decade have varied within fairly narrow range. In late 1960, banks were permitted to count all their vault cash as part of required reserves. For a few months around that time, excess reserves were above normal levels, but they soon returned to around earlier levels as bankers became accustomed to the new regulation and adapted their investment policies to take it into account.

Borrowings at Federal Reserve Banks are the volatile element affecting free reserves, and city banks are the most active borrowers. Their borrowings are influenced by the vigor of loan demands and the relative level of the discount rate. The discount rate is ordinarily kept in fairly close alignment with related market rates, but for the past two years or so it has remained unchanged at the 3 per cent level to which it had been reduced in the summer of 1960 and has been consistently above market rates. (Chart 9). At the same time private loan demand has been moderate. Thus, banks have had little incentive to borrow at Federal Reserve Banks even at the present stage of the business upturn.

For most of the past two years, banks have been able to obtain temporary reserve funds, when needed, at rates generally below the discount rate by borrowing excess balances of other banks in what is called the Federal funds market, a market that has become increasingly more active in the past three years.

Money supply, bank deposits, and related assets. In the past year and a half, an unusually large proportion of funds flowing into commercial banks from the public took the form of time and savings deposits. Such deposits expanded by 13 per cent in 1961, quite a high rate. In the first quarter of 1962 the annual rate of increase accelerated to 25 per cent, but it has since returned to the 1961 rate.

Given the amount of reserves made available to banks by the monetary authorities, the large increases in time and savings deposits adversely influenced the growth in money supply--that is, currency and demand deposits held by the public. In the first three months of 1962, money supply declined slightly from its year-end level. (Chart 10). Partly there were switches directly from demand to time accounts. And partly there were switches from market instruments and other assets to time deposits.

From the statistical evidence it does not appear that much of the rise in time and savings deposits in 1962 represented funds diverted from other savings institutions. Net inflows of funds to mutual savings banks rose in the first quarter of 1962, after allowance for seasonal variation, and remained above their 1961 pace of increase in the second quarter. Net inflows to savings and loan associations in the first quarter were about the same as their high fourth quarter of 1961 rate, but these inflows fell off in the second quarter, paralleling reduced inflows to commercial banks. (Chart 11). But some of the expansion in bank credit appears to have represented a diversion of savings from direct purchases of market instruments, or to a small extent from flows that might otherwise have gone to other nonbank financial institutions, and has, therefore, not represented a net increase in total credit.

Money supply in the hands of the public is about at the average level reached in December, 1961. Contributing to the sluggishness of money supply was the large build-up in U. S. Government deposits until early July, when they were run down to some extent. Though, in fact, Government deposits were rising the Treasury continued security offerings, including a large amount of bills, in anticipation of a rise in Government spending relative to current tax receipts. Most of these short-term issues may well have been purchased by the nonbank public, who in some degree may have reduced idle cash holdings to do so or who may have used cash that might otherwise have financed spending. The public has in effect substituted short-term U. S. Government securities for cash, and they can hold these securities at interest rates that are attractive in periods of economic uncertainty.

Turnover of money. While the money supply has shown little increase, it has been used more intensively to finance the economy's spending, but not intensively enough to accommodate the higher level of spending hoped for. The turnover of demand deposits outside of New York--

in New York turnover is more heavily influenced by financial transactions--was higher in the first half of 1962 than in the second half of 1961. A large part of the increase occurred early in the year, and was possibly related to the sharp initial movement of funds into time and savings deposits. But turnover did rise further in the second quarter, when inflows to time and savings accounts slowed down. (Chart 12).

Turnover has generally risen throughout the postwar period from low levels reached during the 1930's depression and the war years, when the public was keeping itself in a highly liquid state--in one period voluntarily and the other involuntarily. But it has also shown cyclical variations. After adjusting for seasonal variation and for the general trend, deposit turnover has generally declined in recessions and risen in expansions. In New York, however, turnover has often risen in recession and declined in expansion. During the last recession, turnover in centers outside New York did not show as much cyclical decline as in the 1957-58 recession, possibly because of greater public preference for other assets. (Chart 13). It is significant that short-term interest rates declined less in the last recession than in 1957-58.

Whether or not cyclically rising turnover can substitute for growth in the money supply is an important question. Many analysts have contended that turnover has a ceiling and much discussion focuses on whether or not it has been reached or approached. If it were reached, lack of money supply growth would mean lack of economic growth, for at that point the public would be unwilling to economize further on the use of cash balances in order to increase spending.

The trouble with this approach is that it looks only at the observed rate of turnover but fails to measure the strain imposed on the economy by the very act of increasing turnover. At any given time the economy can adapt to a smaller relative money supply and this will show up as increased velocity. The important question is, does the adaptation involve less spending than would otherwise have occurred. One example would be that the inducement to economize cash balances is a high level of short-term interest rates,so high as to place a floor under long-term rates, which in turn inhibits borrowing to finance capital outlays.

Bank credit. With the rapid expansion of time and savings deposits total commercial bank credit outstanding has grown fairly rapidly so far in 1962, although there were slack periods in the early spring and early summer. Of total funds raised in credit markets, almost one-third were advanced by the commercial banking system in 1961 and also the first half of 1962. This was a larger proportion than in four preceding years, except for 1958--years when the supply of reserve funds was under more restraint. (Chart 14).

In managing their loan and investment portfolios, banks this year invested heavily in tax-exempt State and local government issues and also became more interested in longer term loans such as mortgages. During the recession and early in the recovery, they invested heavily in U. S. Government securities, particularly short-term issues. Since mid-1961, however, U. S. Government security holdings have not increased very much. (Chart 15).

So far in 1962, banks have put more emphasis on longer term than on short-term U. S. Government securities. They have reduced their holdings of Treasury bills, and have added to holdings of longer term Treasury issues, in part by participating in new financings. Holdings of all U. S. Government securities maturing within a year increased slightly, however, during the first half of 1962, because of the effect that passage of time has on securities remaining in bank portfolios.

These changes in bank investment behavior have several causes. Incentive to invest heavily in the longer term sectors of the market was provided by the large increase in time and savings deposits that occurred after the first of the year, when maximum permissible interest rates were raised on those deposits. At this point, banks began more actively to seek higher earning assets at some sacrifice perhaps in already high liquidity. Banks had built up their liquidity to rather high levels by mid-1961, through adding to short-term U. S. Government securities at the comparatively favorable short-term rates that prevailed for a period of recession and early recovery. Thus, they were not necessarily eager to add further to liquidity. With loan demand remaining moderate, they sought other relatively high-yielding investments.

Stock market. In supplying funds to markets, investors were influenced in part by an abatement of inflationary expectations, which increased their willingness to make funds available in fixed-value form. There was a shift away from equities as a preferred form of asset holding, particularly at prices and yields that existed earlier in the year, and this culminated in the sharp break in stock prices during spring. The decline in prices seems to have represented in part investors reassessment of stock prices in relation to earnings--in the light of diminished inflationary expectations and of a slowdown in the rate of economic expansion. The reassessment brought stock yields closer to interest rates on bonds, though still below them as they have been since mid-1959. (Chart 16).

Funds Raised in Credit and Equity Markets

The total of funds raised through Government and private security issues and bank and other loans, after allowing for repayments, reached a peak toward the end of last year, and has been lower, seasonally adjusted, in the past six months. But the amount of financing is still above earlier experience, except for late 1958 and 1959. (Chart 17).

The decline has been the result mainly of lowered demands from private sectors of the economy. Federal Government financing has continued to be larger than usual for the first half of a year, with offerings in all maturity sectors. (Chart 18). There were continued Treasury bill offerings throughout the first half of 1962, but in addition there were offerings in longer term sectors through both cash and refunding operations.

In private sectors, including State and local governments, long-term financing in the first half of 1962 has remained fairly substantial, lower than levels prevailing in the last three quarters of 1961, but above late 1958 and 1959. (Chart 19). Demands have been sustained by continued sizable issues of corporate and State and local government securities and growth in mortgage financing. (Chart 20). Short-term demands by private sectors have, meanwhile, fluctuated fairly widely, rising in the second half of 1961, and falling in the first half of this year, when business and other loan demands from banks, particularly loans for purchasing or carrying securities, became less active.

Interest Rates

During the first half of 1962, short-term interest rates have been higher than in 1961, but long-term rates after receding earlier in the year rose about midyear. (Chart 21). The movement of interest rates in the first half of the year was strongly influenced by the public's preferences for time and savings deposits, coupled with commercial banks' investment policies. In addition, short-term rates were influenced by monetary and debt management policies designed to minimize balance of payments strains.

Yields on longer term U. S. Government, corporate, and most spectacularly State and local government issues, declined through mid-spring and then rose. They have not yet reached earlier highs, however. Mortgage yields have continued to drift downwards.

The easing of conditions in long-term sectors of the market earlier in the year reflected for the most part the increased availability of funds that was sparked by the public's response to the change in Regulation Q affecting time deposit interest rates; in addition, there were continued heavy inflows to savings and loan associations and mutual savings banks. The early summer rise in rates was accompanied by a slowing down in the inflow of time and savings deposits to commercial banks and of funds to nonbank savings institutions. In addition, the reserve base of banks has grown more slowly in recent months.

Short-term rates, particularly the market yield on 3-month Treasury bills, have fluctuated within a range of 2-5/8 to 3 per cent since the first of the year, after fluctuating between 2-1/4 and 2-5/8 last year. Most recently, they have been in the upper part of the range.

Commercial bank investments in longer term assets have been a contributory factor to maintenance of the short-term rate at this level in a period of reduced demands for short-term credit. In going long, banks have reduced Treasury bill holdings, as I have already mentioned, either through sales or by letting them run off. This has added to upward pressures on the bill rate. Thus, one effect of the liberalization of Regulation Q at the beginning of this year was to add to downward pressures in the long-term sectors of the market, which reduced the cost of financing housing and business plant and equipment, and to upward pressures in the short-term sectors.

Bank portfolio choices were not the only factors impinging on short-term rates, of course. To help the balance of payments situation, the Treasury offset downward pressures on the bill rate by increasing its offerings of short-term issues. Federal Reserve open market operations also served at times to moderate downward pressures on short-term rates. These actions served to minimize incentives for short-term capital to flow abroad. But they may also have had the effect of keeping long rates from declining more and, hence, domestic spending from rising more, mainly because short-term rates made liquidity too attractive in this period of uncertainty.

Concluding Comments

The economy's performance in the first half of the year has been below the expectation of most and the hopes of all, but we should nevertheless view it with a confidence that is commensurate with the resilience and strength shown in this period. The stock market reappraisal, the shift in fiscal operations, the inventory adjustment growing out of the steel settlement have each probably had significant dampening effects on the real economy.

The banking system appears to have responded to the actions of the Federal Reserve about as one would expect. Bank liquidity changed little in 1962. (Chart 22). The level of excess reserves at the country banks averaged $500 million in the last half of 1961 and $440 million in the first half of 1962--about the same as in the past five years. The reserve city banks kept their own positions in close balance but were reluctant to go into debt at the 3 per cent discount rate, given the apparent demand for loans and prevailing yields on investments. In this situation, without evident strong demand for bank loans from the economy, expansion in money supply came to a halt before the beginning of this year. In their capacity as savings institutions banks extended credit commensurate with the increase in their time and savings deposits.

The public's response has been more enigmatic. We do know that with the rising level of GNP, the intensity with which the money supply has been used continued to rise secularly and also cyclically. High yielding liquid assets gained in appeal--the idea of earning 4 per cent on funds that were as good as cash and the promotion of this idea by financial intermediaries in a competitive struggle undoubtedly was a restraint of some kind on spending.

Looking at the figures, the total of liquid assets in the hands of the nonbank public has been rising faster than gross national product in the first half of the year. In expansionary periods the ratio of liquid assets to gross national product usually declines, as it did during most of 1961. (Chart 23). So far as credit flows are concerned, total credit flows in the first half of 1962 were lower in relation to gross national product than they were in the first half of 1959, about the same stage of the earlier cycle. Similarly, private borrowing is lower in relation to expenditures, other than those by the Federal

Government, for goods and services, than was the case in the earlier period. (Chart 24).

We come down to the basic question of the past 6 months, could monetary policy have made a greater contribution to our over-all economic well being? The slower expansion thus far in 1962 suggests that a more aggressive monetary policy involving greater credit availability might have led to a fuller utilization of resources. The concern with the level of short-term rates has been a key factor in inhibiting policy. Against the possibility of more rapid economic growth we have had to balance the risk that reduced interest rates and greater liquidity might have worsened our balance of payments further.

Chart 1
MEASURES OF ECONOMIC ACTIVITY

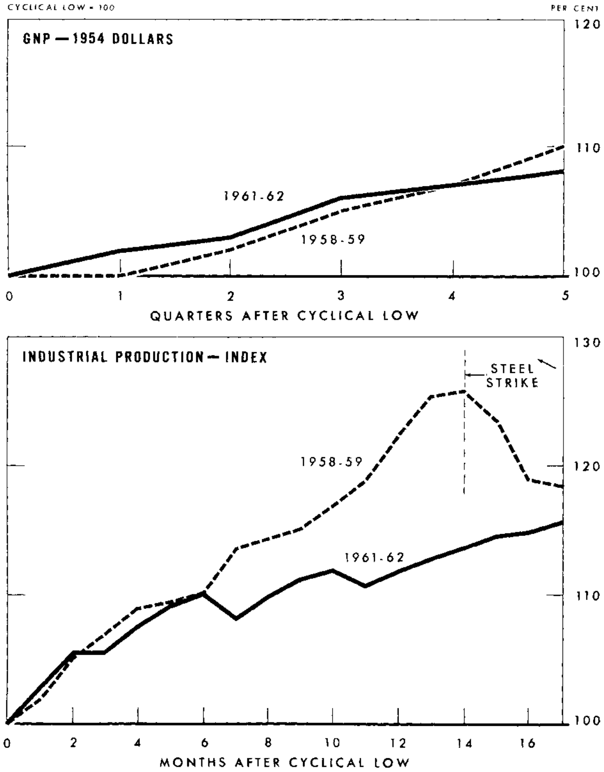

Chart 2
MEASURE OF RESOURCE USE

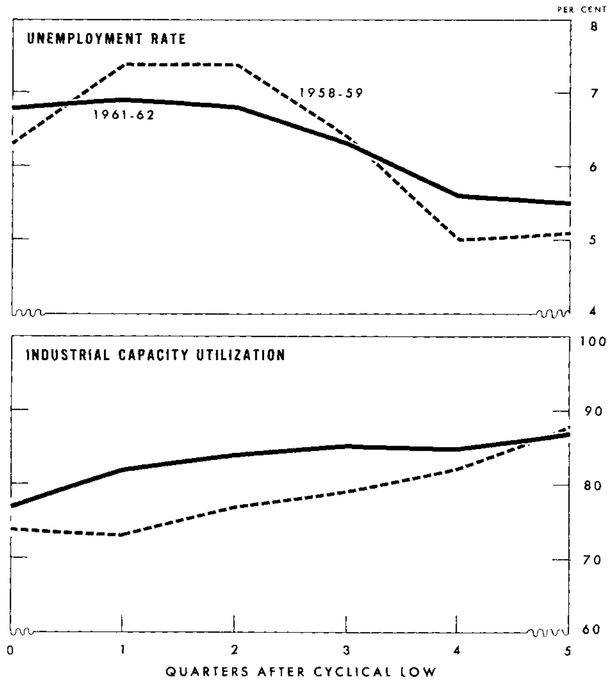

Chart 3
PRIVATE INVESTMENT EXPENDITURES

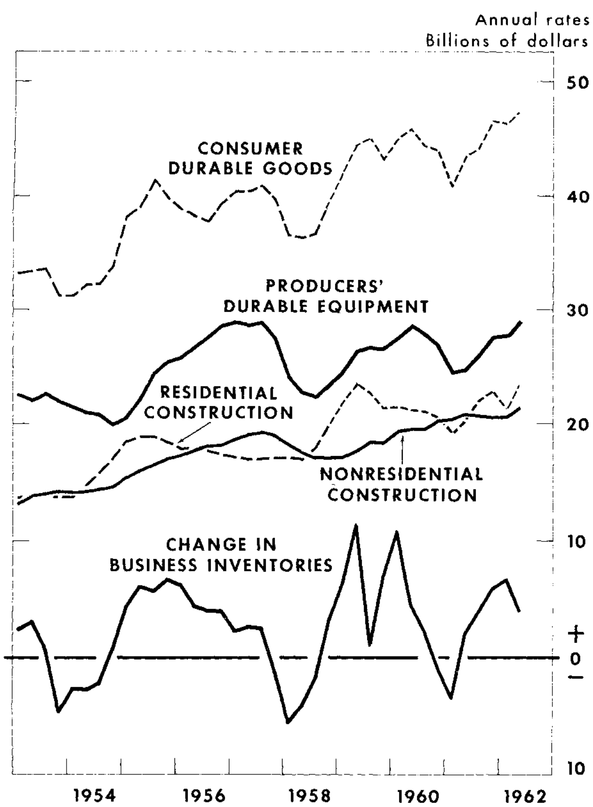

Chart 4
GOVERNMENT PURCHASES OF GOODS AND SERVICES
DEPARTMENT OF COMMERCE ESTIMATES, ADJUSTED FOR SEASONAL VARIATION

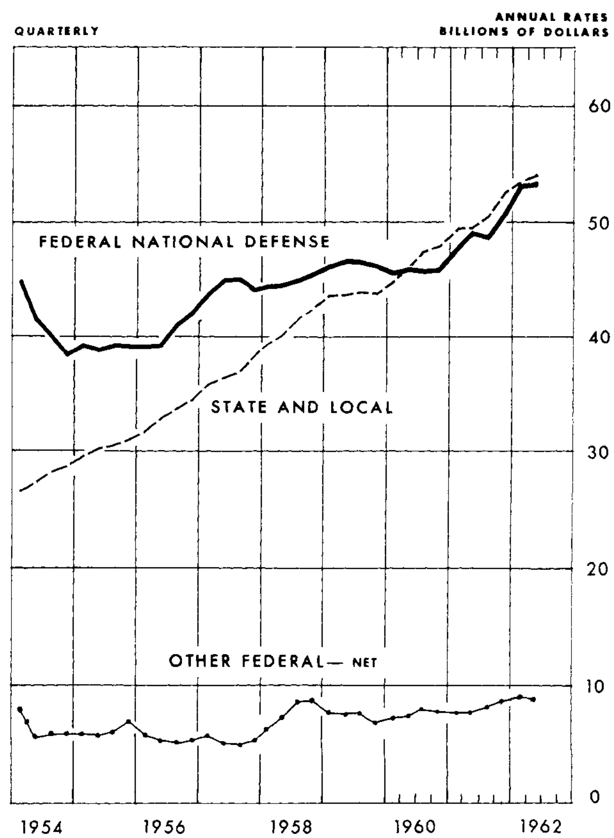

Chart 5

WHOLESALE PRICES

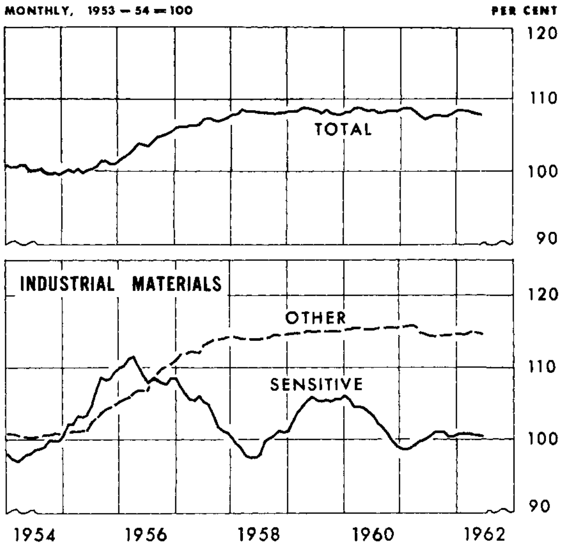

Chart 6

PRIVATE SPENDING IN RELATION TO INCOME

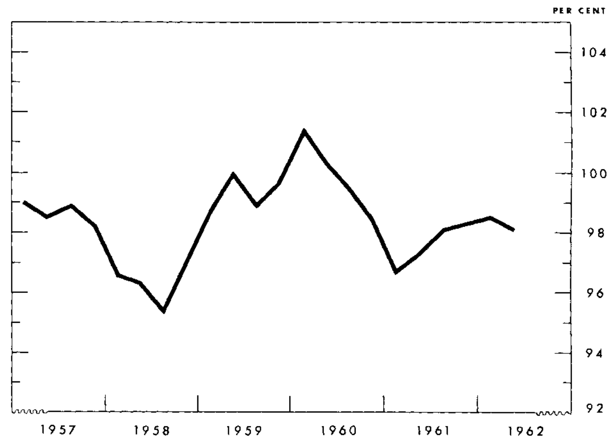

Chart 7

U.S. BALANCE OF PAYMENTS

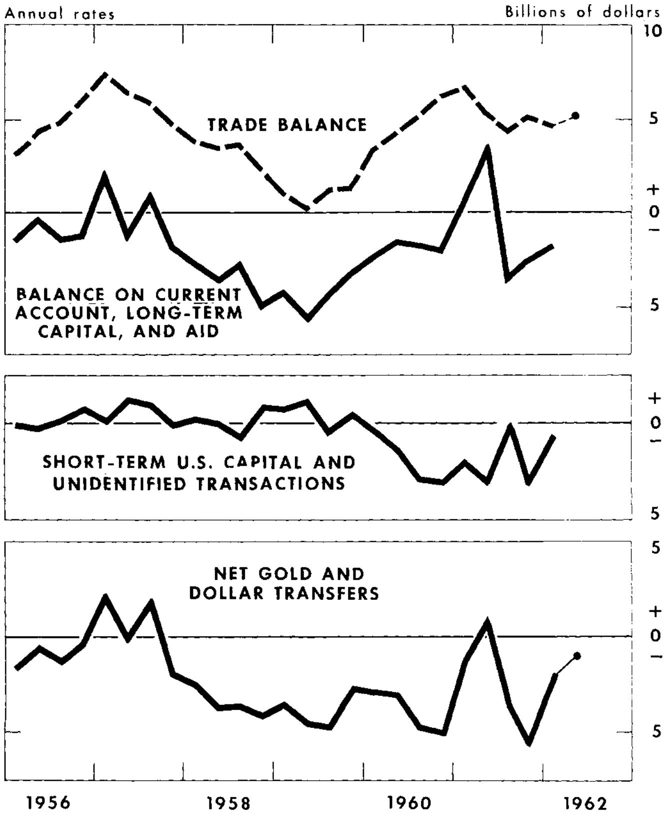

Chart 8

MEMBER BANK RESERVES AND BORROWINGS

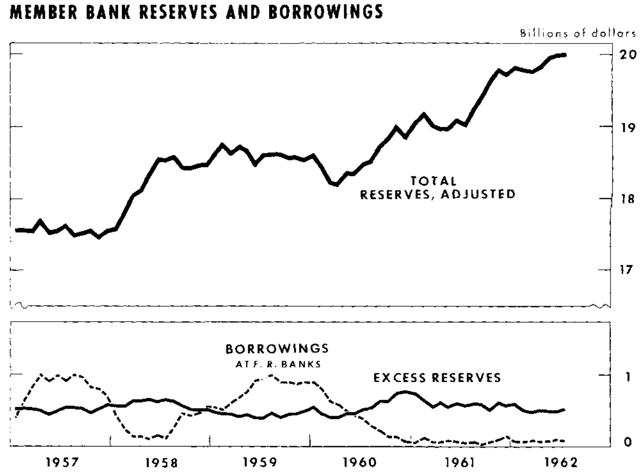

Chart 9

DISCOUNT AND OTHER SHORT-TERM RATES

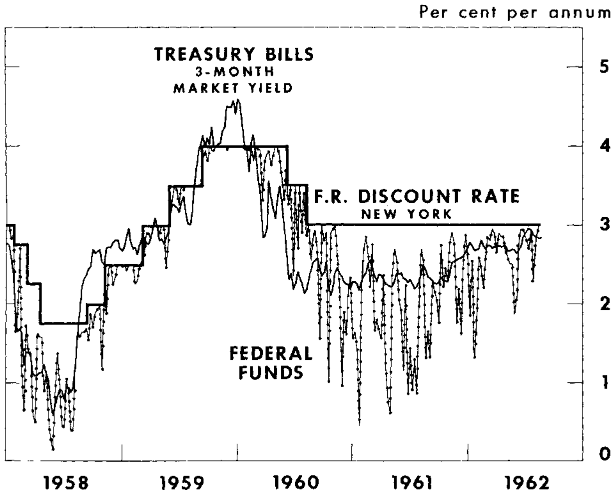

Chart 10

MONEY AND TIME DEPOSITS

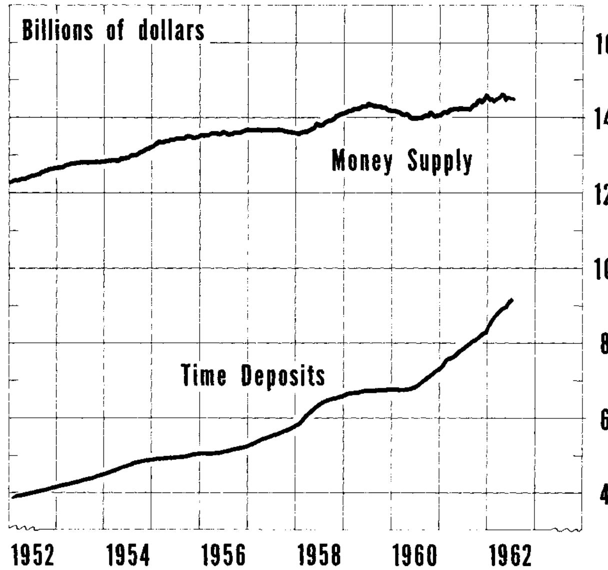

Chart 11

NET SAVING INFLOWS

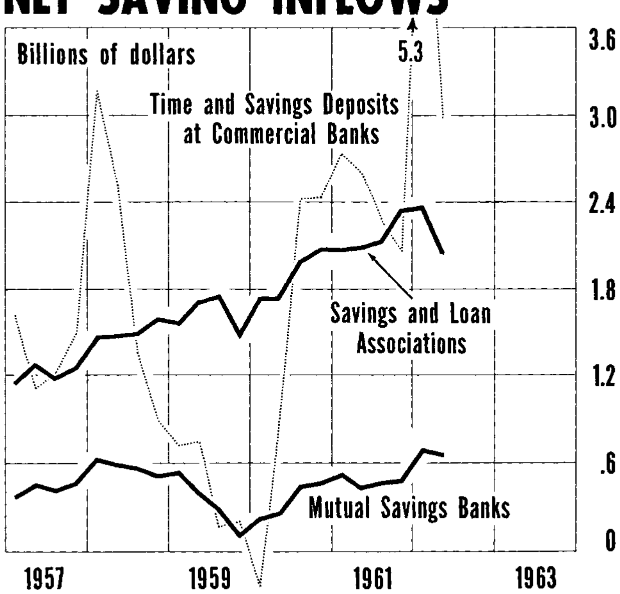

Chart 12

TURNOVER OF DEMAND DEPOSITS

AT BANKS IN SELECTED CITIES

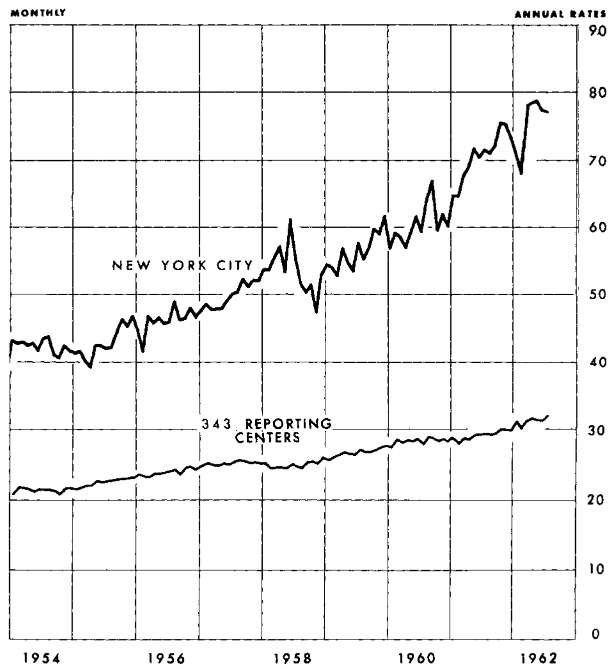

Chart 13
CYCICAL MOVEMENT IN TURNOVER
PERCENTAGE DEVIATIONS FROM TREND

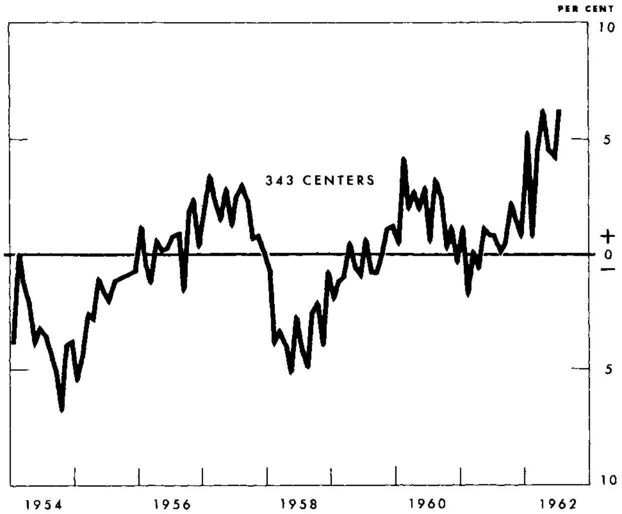

Chart 14
FUNDS ADVANCED IN CREDIT MARKETS

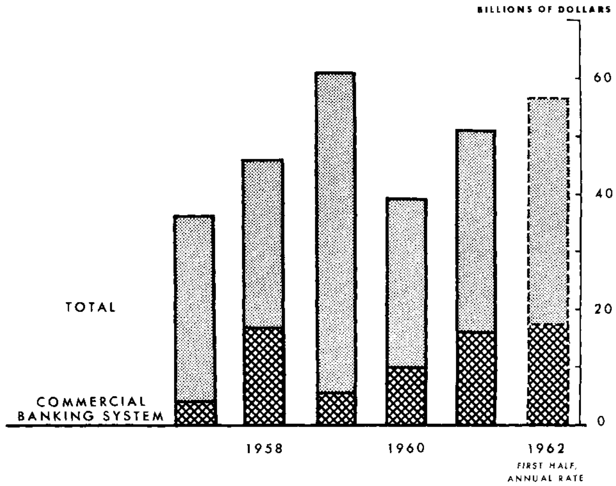

Chart 15
BANK LOANS AND INVESTMENTS

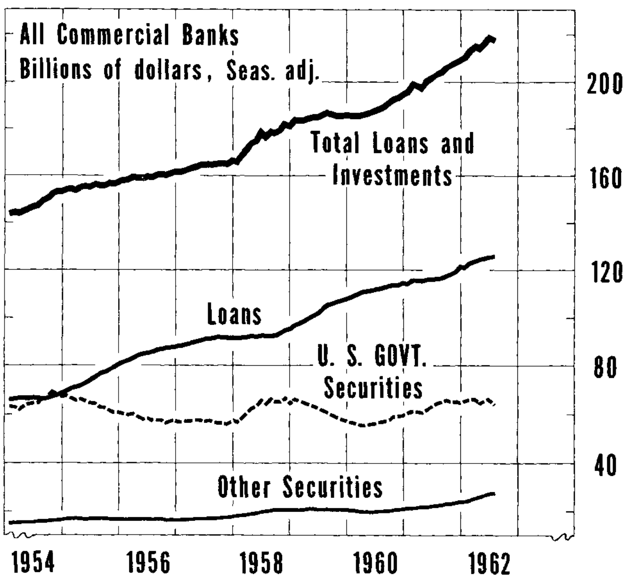

Chart 16
STOCK MARKET

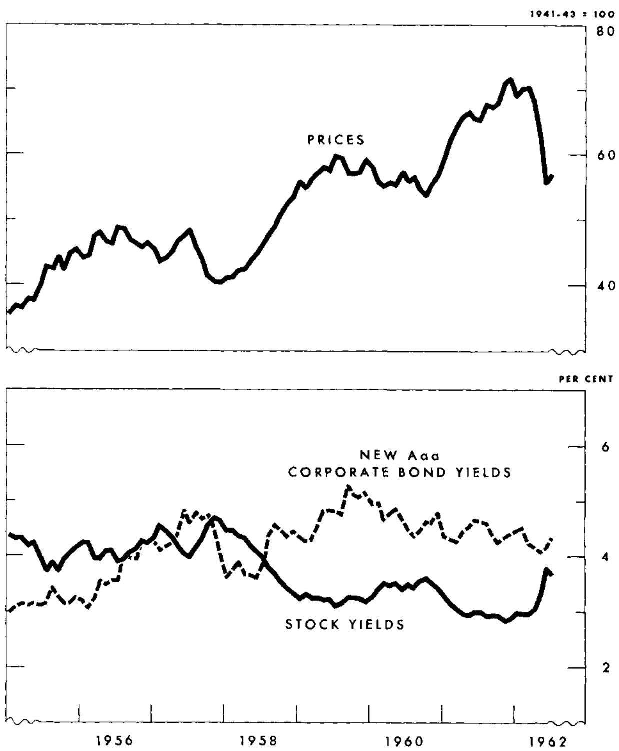

Chart 17

FUNDS RAISED IN CREDIT MARKETS

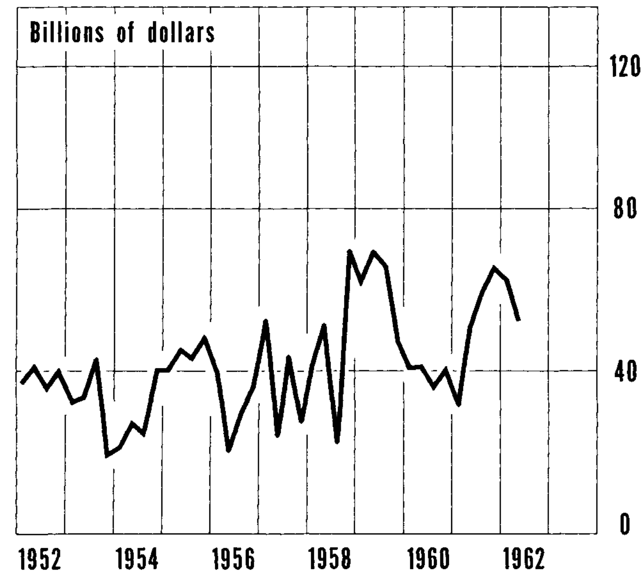

Chart 18

CREDIT AND EQUITY FLOWS

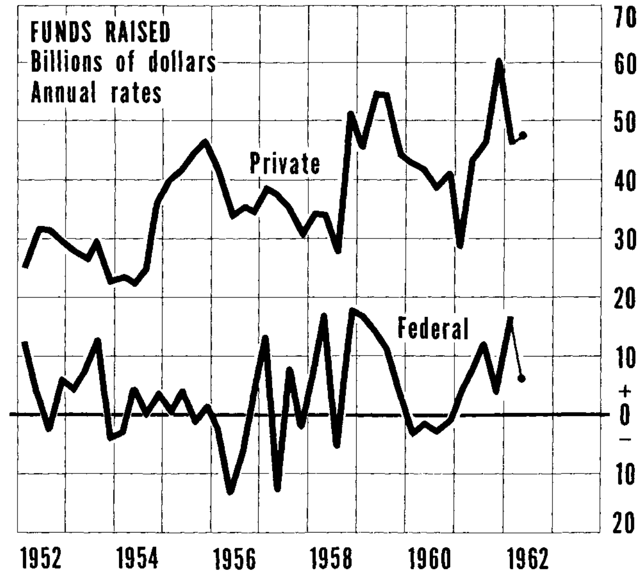

Chart 19

CREDIT MARKET FINANCING

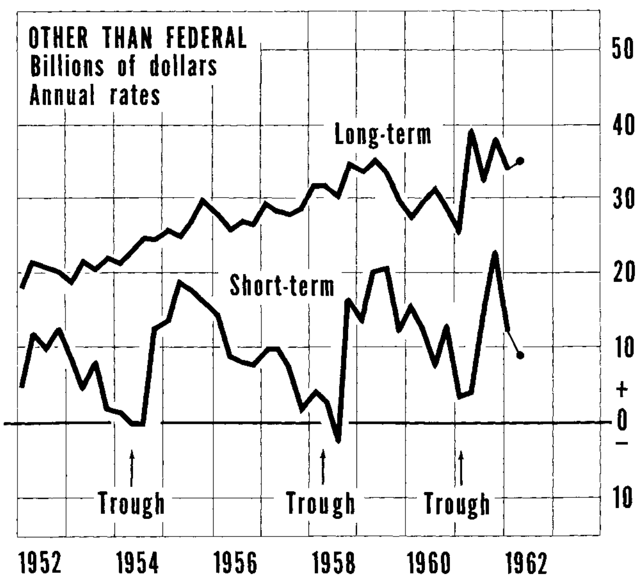

Chart 20

LONG-TERM FINANCING

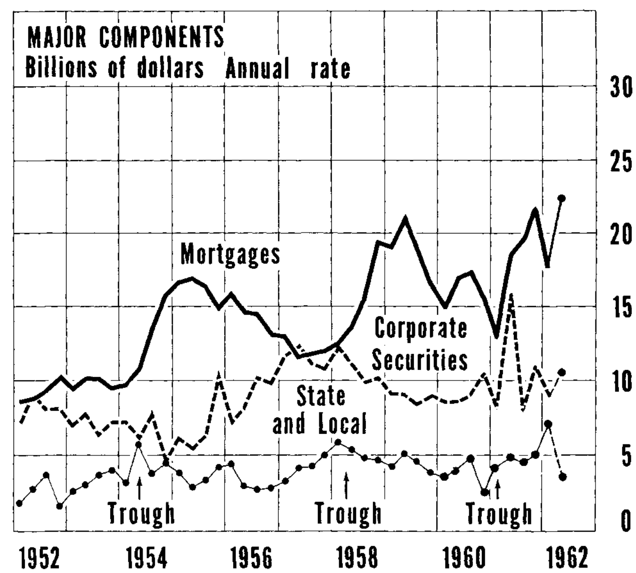

Chart 21

MONEY RATES

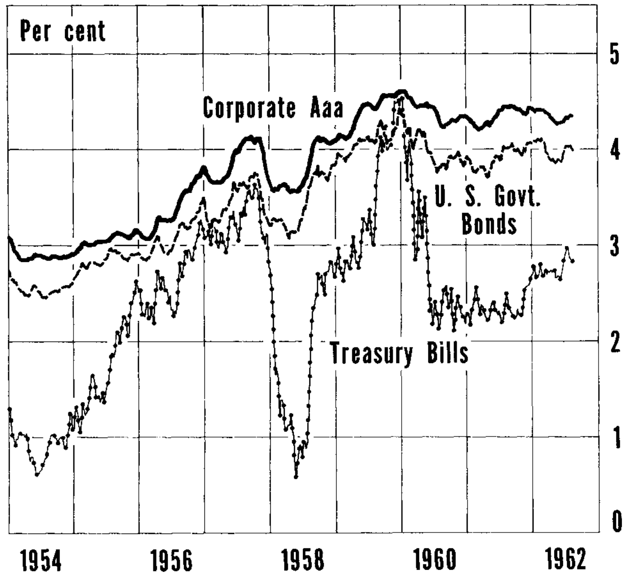

Chart 22

COMMERCIAL BANK LIQUIDITY

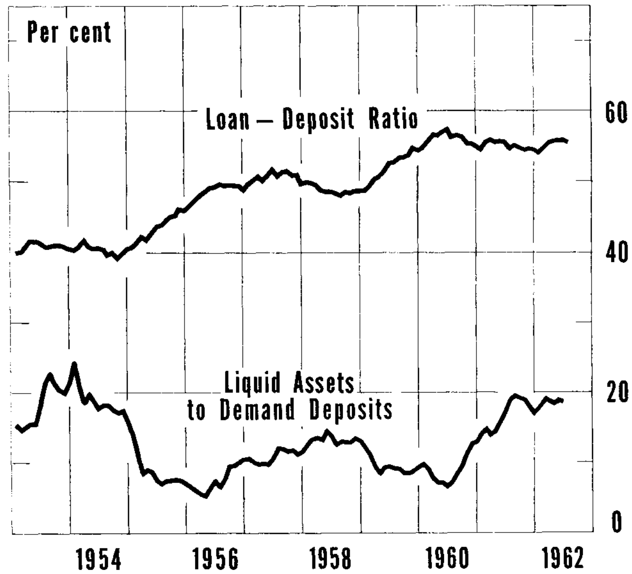

Chart 23

LIQUID ASSETS AND G N P

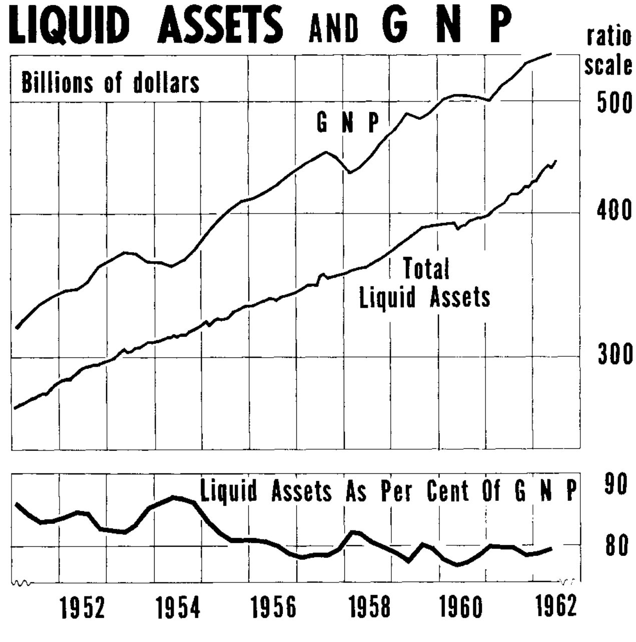

Chart 24

BORROWING AND GNP