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Economic Policy in the Months Ahead

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ECONOMIC POLICY IN THE MONTHS AHEAD

Economic developments during 1964 have been encouraging from a variety of vantage points. Individuals have realized higher after-tax incomes, and businesses have seen their profits soar to record levels and then continue on upward. The economic growth targets of national policy are nearer; in real terms, output of goods and services during the third quarter was almost 5 per cent higher than a year earlier. True, the problems of unemployed labor resources and idle industrial capacity are not behind us, but progress has been made on both counts. Important to most of us is the fact that these economic gains have not been compromised by a pervasive advance in prices. The consumer price index in recent months continues, as it has in recent years, to show no more change than probably is offset by quality accretions. Wholesale price trends are mixed, as should be expected, but in the aggregate the index has remained virtually stable.

Growing concern, which I share, is being expressed, nonetheless, lest the prolonged economic expansion we have enjoyed since early 1961 culminate in an inflationary spiral. In my view, concern stems from developments in the nonfinancial sectors of the economy; the shortages of skilled labor that have accompanied the reduction in unemployment, some generous wage settlements, the upward adjustments in prices of certain basic raw materials and the potential emergence of speculative inventory policies. In some quarters, apprehensions about inflation result from a belief that recent monetary policy has been over-stimulative, and in 1964 is generating excessive additions to private liquid assets. After several years of substantial expansion in commercial bank deposits and earning assets, continued ease in 1964--so the argument goes--is propelling the economy toward inflation. If a monetary inflation were upon us I would have no hesitation in advocating monetary action to combat it, but I do not share the view that a credit-based inflation presently exists, primarily because I cannot subscribe to the interpretation of monetary policy that underlies this view. In my judgment, the role of monetary policy in 1964 is correctly characterized as an accommodative influence permitting other sources of stimulus--in particular, the Federal income tax reduction--to have their full impact on spending, employment, and business activity.

In a growing economy, an accommodative monetary policy permits the banking system to adjust to expanding credit demands, allowing it to share in meeting external financing requirements of business, government, and consumer without material change in the cost and availability of borrowed funds. In this view, growth in the money stock and time deposits takes place in step with the enlarged demand for these financial assets that accompanies rising incomes and transactions needs. Also, an accommodative monetary policy permits variations in the growth rate of the money stock and time deposits in response to shifts in preferences of the public among classes of financial assets. This is, I believe, the course pursued by monetary policy in 1964.

Measures of Monetary Restraint and Ease

Differences in view as to the propriety of a given monetary policy often arise from reasonable shadings in judgment and interpretation of facts pertinent to monetary decisions. But perhaps even more often differences in view arise from dogmas, misunderstanding of the monetary process, or the simple failure to define what one means by an easier or tighter monetary policy.

To illustrate, the dogma that changes in money supply cause roughly proportionate changes in economic activity in some subsequent period ignores the fact that the economy's legitimate needs for money as a transactor may be the generative force behind changes in the money supply. The relationship between money supply and economic activity is not necessarily a one-way street. It is far more probable that money and activity interact in a complex manner. We could trace this interaction in some degree if we knew how intensively various sectors in the economy were using their money stock and the influence of gross inflows and outflows on their net holdings.

To illustrate another point, consider briefly the meaning of the terms monetary ease and restraint in terms of the measurements applied to them. By custom, these terms are associated with levels and changes in several financial variables, but which are the most relevant and reliable variables is not always clear when they are giving inconsistent results. Total bank reserves, member bank borrowings, free reserves, money supply, total bank deposits, interest rates and others have all found favor, at one time or another, as guides to the posture of monetary policy.

Financial economists recognize that some of these variables are properly used only as a very short-run guide to policy changes, and center their main attention on the financial variables they believe are mostly closely associated with the impact of monetary policy on spending. There are two principal views on this question. One view is that the degree of ease or restraint produced by Federal Reserve policies, interacting with private decisions to borrow and spend, is reflected in changes in the stock of money. The other focuses attention on the impact of policy actions on conditions in the credit markets. This is more than a theoretical issue of mere academic interest, as developments in 1964 indicate.

So far this year the active money supply (currency and demand deposits) rose 4.2 per cent at annual rates, a considerably higher growth rate than the average of the past 10 years. From May through September, the annual rate of increase was even higher, nearly 7 per cent; in the past three months it has dropped back to 4.2 per cent.

The over-all rate of advance this year, and especially since May, is regarded with alarm by some observers. This concern has been heightened by the continued rapid expansion in commercial bank time deposits. Time deposits rose 11 per cent, at annual rates, during the first three quarters--somewhat less rapidly than in 1962 and 1963, but at high rates by historical standards. Growth in money balances and time deposits together amounted to almost 30 per cent of total funds raised by all nonfinancial sectors of the economy in the first three quarters of 1964, about the same percentage as in the three previous years. Between 1951 and 1961, the percentage was this high only in 1954 and 1958, when Federal Reserve policies during a major part of the year were expansive.

Judged solely by increases in the stock of money, or by growth in money and time deposits, 1964 appears to be a year of substantial monetary stimulus. But the behavior of credit market conditions suggests an entirely different characterization. Interest rates are presently at high levels by historical standards, though credit availability is ample, judging by the sketchy evidence we have to draw upon. There is little to indicate that non-price terms of credit contracts have eased further this year, however, and interest rates have been remarkably stable.[1/] The current state of credit market conditions is thus somewhat ambiguous, but credit market developments in 1964 clearly have not shown a pattern associated with monetary policies generating an excessive stimulus to economic activity. Those who would judge the impact of monetary policy by observing credit market conditions could hardly conclude that the Federal Reserve has been "an engine of inflation" these past ten months.

I have always been sympathetic with the view that changes in the stock of money are a vitally important guide to the conduct of Federal Reserve policy. I am not prepared to relinquish this judgment in favor of exclusive concentration on the behavior of interest rates or other measures of credit market conditions. But I do think the time has come when judgments about the character of monetary policy derived by observing changes in the money stock can and should be more sophisticated. My suggestion is that we need to recognize the existence of variations in demand, as well as in the supply, in assessing the implications of growth in money balances and time deposits. When such variations are taken into account as adequately as available knowledge permits, differences in the "credit conditions" and the "money supply" interpretations of Federal Reserve policy are narrowed materially.

1/ Yields:

	Weekly Averages		
	October 30	1964 High	1964 Low
Treas. 90-day bills	3.56	3.58	3.43
Treas. 3-5yr. issues	4.03	4.23	3.98
Treas. long term	4.15	4.20	4.11
Corp. Aaa	4.43	4.43	4.35
Corp. Baa	4.81	4.87	4.80
State & local Aaa	3.11	3.16	3.07
State & local Baa	3.56	3.59	3.51

Let me illustrate the meaning of this suggestion, first, with reference to the growth we have experienced in the money supply and time deposits during the past several years.

The Demand for Total Bank Deposits

Institutional changes since early 1961 have increased greatly the attractiveness of time deposits relative to other financial assets. Ceiling rates on time deposits have been raised twice--at the beginning of 1962 and again in mid-1963. In both cases, commercial banks promptly increased rates paid. Development of a market for negotiable CD's also has been of great significance in making time deposits an attractive liquid asset to corporations and other large investors.

Part of the increase in the public's demand for time deposits that accompanied these developments, to be sure, reflected a reduction in desired holdings of money balances. Had it been confined to that, the composition of money supply and time deposits consistent with full employment and price stability would have been changed, but the necessary total growth of money supply and time deposits combined would not have been altered.

Time deposits are not merely substitutes for demand balances, however. They are also close substitutes for claims against nonbank financial intermediaries and open-market securities, and demands for these financial assets were reduced by the increased attractiveness of time deposits. As a consequence, the growth rate of demand for total bank deposits was raised appreciably.

Federal Reserve policy measures permitting an increase in the growth rate of deposit supply, in response to this shift in demand, are clearly not expansionary. They are accommodating actions that prevent the growth in demand for total bank deposits from being frustrated, and thus exercising a drag on economic activity. Monetary, no less than fiscal, drag has deflationary implications.

It is in this context that the rapid growth of total bank deposits since the end of 1960 is properly comprehended. Privately held bank deposits have been advancing since then at annual rates ranging from $14 to $20 billion, and have amounted to approximately 30 per cent of net funds raised by all nonfinancial sectors of the economy. This generous a contribution of the banking system to total credit supplies in periods of monetary stimulation resulted in sharp reductions in the level of interest rates on open-market securities--as the experience of 1954 and 1958 indicates. But under current circumstances, bank deposit growth of this general magnitude was essential to provide the public with the additional bank deposits it wished to acquire, as economic activity advanced, at the existing pattern of yields on time deposits and other financial assets.

Recent Growth in the Money Supply

The new element in this picture in 1964 is the recent acceleration in growth of the money supply. Data required to interpret this development with complete confidence are not yet fully available, but there is reason to believe that it falls in the category of changes in financial asset preferences properly accommodated by monetary policy. From present information, it appears that a turnabout has occurred in corporate liquid asset management, with a resulting increase in demands for transactions balances.

Corporations have become increasingly adept at economizing money holdings, and corporate money velocity has risen almost continuously since the end of World War II. Until recently, this economization has been relative, not absolute; corporate money holdings have increased over the postwar period at an average annual rate of about $1 billion.

Introduction of negotiable CD's and higher time deposit rates since early 1961 were accompanied by changes in corporate liquid assets of a more radical character, and have resulted in a sharp decline in corporate money balances during the past several years. Turnover rates of demand balances at New York City, and six other financial centers where corporate balances predominate, provide confirming evidence of a marked change in corporate cash assets. These turnover rates have shown average annual increases since 1960, much larger than those typical of earlier years.

The rundown of money holdings accompanying expanded corporate holdings of CD's could not have continued indefinitely. Eventually, normal growth of transaction balances had to be resumed, adding to demands for money. That is what seems to have happened this spring, since present estimates suggest that corporations began enlarging their money holdings at an annual rate of about $1 billion in the second quarter. This contrasts with a decline of $2 billion in 1963, implying a net increment of $3 billion in corporate demand for money. The rising trend in corporate money holdings may have continued in the third quarter, since the growth of outstanding CD's at commercial banks slowed during the summer months.

This interpretation of the recent money supply growth must remain somewhat conjectural until it can be tested and buttressed as additional information becomes available. But there is, I believe, strong confirming evidence that recent growth in money supply has not outrun the expanded demand for money generated by rising economic activity and shifts in preferences for financial assets.

Excessive increments to the money supply contribute to economic instability by spilling over into other markets. If the spillover occurs in inventories and commodity markets, spending on goods and services begins to rise more rapidly. Accelerated money supply growth since May has not had this effect; total demands for goods and services in the third quarter rose no more rapidly than earlier in the year or in the latter half of 1963. If the spillover occurs in markets for financial assets, interest rates begin to decline. This characteristic has also been lacking. In fact, short-term interest rates have inched upward since midyear. Evidence that growth in the money supply has been excessive is thus conspicuously absent.

Policy Implications

This line of reasoning, then, leads me to the conclusion that monetary policy has not been an undue stimulating factor in 1964, but an accommodating factor permitting the orderly expansion in economic activity to continue. Unless the expansion exerts more pervasive pressures on prices, or begins to display trends that are evidence of unsustainable growth, I see no reason in the domestic situation why the posture of monetary policy should change.

Looking to the future, there is an impressive need for continuing large increases in output of goods and services if further progress is to be made in drawing idle resources into gainful employment. Productivity has been advancing rapidly--at an annual rate of about 3.5 per cent--and the civilian labor force has been rising at a rate of 1.3 million persons per year. Continuation of these trends would require further growth in real output at a rate close to that of the past year if unemployment is to be reduced further.

Manufacturing capacity also is rising very rapidly. If business fixed investment continues to grow at a pace close to the 1964 advance, large further gains in consumer spending will be needed to absorb the increased output of goods and services made possible by growth in productive capacity. Since the effect of the tax cut on consumer disposable income is now largely behind us, further increases in consumer spending in the amounts we have seen in the past two quarters will require a significant decline in personal saving rates from recent levels.

The momentum of the recent advance in business fixed investment programs and consumer spending provides reasonable assurance of a continued rise in total demands for goods and services in the near-term. Inventory investment also is likely to add strength to the economy, rising from the unusually low accumulation rate of the third quarter.

An increase in the rate of inventory investment to a range of perhaps $4 to $6 billion--the accumulation rate that obtained in 1962 and 1963--would make a useful contribution to current output under present circumstances. It would also be consistent with growth in stockpiles necessary to expansion in sales and production. Inventory developments could, however, become a source of concern in the months ahead, if the anticipation of a steel strike or a markup in steel prices led to large speculative additions to existing stocks. The sustainability of growth would then be threatened and restrictive monetary actions might well be called for. Wage settlements and price policies in other industries also will need to be kept under close scrutiny. Appropriate private responses, no less than public policies, are essential if we are to avoid inflationary pressures in the movement toward higher levels of resource utilization.

These potential sources of inflationary pressures will be matters of serious concern in the months ahead. But we should not let them absorb our attention so completely as to overlook a problem of quite different character--the need to foster all sustainable forces of expansion now, in order to prolong current rates of growth during 1965. Federal Government spending for goods and services seems to have reached a plateau, and the tonic of the Federal tax cut has had its principal impact already. Residential construction has begun to tail off, after several years of substantial increases in activity, and while housing starts may stabilize near present levels, this sector shows little promise as a significant source of stimulus in the months ahead. The McGraw-Hill survey data on business fixed investment plans (released just Friday) suggest, moreover, that a slower pace of business capital outlays might develop in 1965

Longer-run considerations suggest that public policies in the foreseeable future may be increasingly directed at sustaining, if not stimulating, a lagging economy. Actions of this nature are not called for presently, given the current momentum of business activity. But it would be equally premature to take restrictive actions now to counter inflationary developments that are, as yet, only possibilities that we may be fortunate enough to avoid.