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Monetary Policy and the Economy: 1967 and 1968

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Monetary Policy and the Economy: 1967-1968

Monetary policy and the economy sounds like a straightforward topic--and I wish it were--but it isn't. What we mean by the economy is fairly clear; it's the level of employment, the standard of living, the rate of economic growth, the cost of living. But what we mean by monetary policy is subject to considerable dispute.

To one school of thought, monetary policy is measured by the money supply--narrowly construed to include currency and demand deposits held by private sectors of the economy, or perhaps more broadly construed to include time and savings deposits at banks as well. When the money supply goes up more rapidly than it had been, monetary policy is said to ease; and when it goes up less rapidly, or declines, monetary policy is said to tighten.

To another school of thought, monetary policy is measured by the cost and availability of credit. To this school, policy is tightening as interest rates rise, and is easing as interest rates fall.

You can readily see that conflicts of interpretation can and will develop. There are times when both the money supply and interest rates may be rising. Is money then easy or tight? Or there may be times when both the money supply and interest rates are falling. Under those circumstances, the money supply school will tell us money is becoming tighter, and the credit school will tell us monetary policy is becoming easier. These schools of

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thought are not confined to academic circles--they now have adherents in congressional and commercial banking circles. Each receives regular attention in the daily financial press. Obviously both are represented in the Federal Reserve System. How do we decide which is right?

Part of the problem is in the way the question is asked. It does not really matter whether we can find an indicator, or set of indicators, which will provide an unequivocal answer under all circumstances to the question of whether monetary policy is becoming easier or tighter. What matters is whether financial conditions are tight enough, or easy enough, to achieve a satisfactory level of economic activity and growth. The ultimate test of monetary policy is not to be found in what happens to the money supply or to interest rates, but in what happens to the economy--to prices, employment, growth, and the balance of payments. And the appropriate question to ask of the monetary authority, or for the monetary authority to ask itself, is what needs to be done in financial markets to attain satisfactory and sustainable economic conditions.

The problem is elusive when looked at this way, not only because of the variety of financial markets and assets and their relation to economic activity, but also because many of the effects of monetary policy are not transmitted instantaneously. An economy whose current performance is conforming to our goals is, in fact, responding not only to current monetary actions but also to earlier monetary maneuvers. In a changing environment, with a variety of

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fiscal and monetary mixes to point to in the recent past, there is plenty of elbow room for diverse theories and judgments associating or disassociating specific past actions with the economy's current performance. And, as is often the case where variable leads and lags are involved and linkages are obscured, the problem of identifying which is cause and which is effect also becomes a source of disagreement. We may be able to agree that changes in interest rates, money holdings and credit flows, can be affected by changes in the public's preferences for particular financial assets. And we may agree these monetary variables can also be affected by the monetary authority's intervention whether such intervention takes the form of altering the rate at which it supplies reserves to the banking system or the conditions under which the banking system can utilize these resources. But in any particular episode there can be substantial disagreement as to the weight appropriately assigned to supply or to demand factors.

Sometimes these disagreements emerge as the issue of how does the monetary authority know what _it_ is doing, in contrast to what is being done _to_ it by market and economic forces. This is a real problem, which I would like to clarify by trying to flesh it out through example and experience.

Relation Between Financial Markets and the Economy

When the monetary authority asks what has to be accomplished in financial markets to keep the economy moving satisfactorily, it

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must start with a knowledge of existing financial conditions and how these affect, or are linked to, the spending of businesses and consumers. It must also start with a knowledge of the Federal Government's spending and tax policy--that is, of fiscal policy. Of course no knowledge is perfect, and the central bank, as well as every other decision-making body, makes its judgments surrounded by various uncertainties. In the case of the central bank, there are uncertainties as to how much private sectors will be spending in the future; there are uncertainties about the nature of the linkage between changes in certain financial conditions, like mortgage interest rates, and related spending; and there are uncertainties about how fiscal policy will evolve out of the sometimes conflicting pulls of the Congress and the Administration.

Basic to monetary policy formulation, then, is a forecast of economic activity, prices, and the balance of payments over a period ahead, given existing financial conditions and prospects for fiscal policy. The likely course of the economy is not dependent on existing financial conditions alone, but it is also influenced in an important degree by past financial conditions. And, finally, I might add that economic activity to some degree has a momentum all its own, given some reasonable range of financial conditions, with business investment, for example, dependent on past sales to consumers or on defense orders, and with price behavior dependent on wage developments and vice versa.

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A good illustration of the linkage between credit markets and spending, and one that has received considerable publicity in recent years, is the relationship between building activity and conditions in the mortgage market. The mortgage market is subject to a variety of influences from the supply side, the chief of which are inflows to savings and loan associations and mutual savings banks and yields available on other long-term investment instruments, such as corporate stocks and bonds, which affect the willingness of insurance companies, for instance, to make mortgages. And since home building requires a fairly long planning stage and start-up time, it is mortgage market conditions over a past period of several months which have an affect on tomorrow's building activity, although expectations of this activity are generated by the mortgage commitments made to builders, which show a much earlier response to inflows.

Another crucial area of the financial markets is the cost and availability of credit to businesses and consumers from banks. This depends on the extent to which banks can effectively compete with other financial institutions for savings of individuals or can offer time instruments at an interest rate that will attract funds--from corporations or State and local governments--which might otherwise flow into market securities, such as Treasury bills. The ability of banks to make loans also depends on the public's willingness to hold a portion of its assets in the form of demand deposits; and this willingness in turn depends on the level of

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interest rates, expectations about future interest rates, and current transactions needs stemming from economic and financial activity.

Finally, and without attempting an all inclusive listing of relevant credit areas, I should mention the cost of long-term borrowing. The current, and also expected, levels of long-term interest rates affects the timing of capital market borrowing by business corporations and State and local governments. And it also appears to have some influence on spending decisions, or on the timing of long-term investment projects, particularly those in which borrowing costs are a significant share of total costs, such as for transportation and various kinds of public utilities.

How Does Money Fit In?

The main point I want to bring out by cataloguing relations between credit and spending is to indicate that the great bulk of the links between finance and spending do not involve money supply, as such, but do involve the availability, terms, and cost of credit-- in short, how much you can borrow, when, and under what terms. Thus, if the central bank wants to change existing financial conditions because the economic outlook is weak and spending needs to be encouraged, it will provide more reserves to the banking system; and in so doing will act to push down interest rates generally, increase the availability of lendable funds to banks, and make it easier for other savings institutions to attract funds and channel them into, for instance, the mortgage market.

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You may then ask how does the money supply fit into this picture? It fits in a number of ways, but let me highlight one. Often an increase in money supply is the result of growth in income. As income grows, people receive more cash and need more cash for the enlarged volume of transactions, always recognizing that over the longer run we are using technology in more and more ways to economize on cash. But if the money supply is growing much more rapidly than income, this may indicate that the public is increasing its liquidity, and are putting themselves in a position to spend more in the future. However, it is obvious--once so much is said--that the money supply alone is not indicative of liquidity. Funds held in time and savings deposits, saving shares, and short-term market instruments are almost as liquid as cash, and can be readily spent with no or little sacrifice in capital value.

Thus the money supply would appear to be one--but only one--element in the liquidity position of the public. And if liquidity is built up, it is possible for consumers, businesses, and State and local governments to maintain spending in some degree when credit is tight by drawing down their liquid assets. Indeed, a recent survey we made of the behavior of State and local government units in periods of tight money indicates that large governmental units in relatively liquid positions were not as pressed as others to cancel contracts at the same time as they cancelled bond offerings, because they could tide themselves over by drawing on liquidity.

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But liquidity, once used, ordinarily is later rebuilt, so that it does not for long provide what some have called an escape from monetary policy. Yet it should not even be considered as an escape. Rather, an erosion of liquidity--measured to include all relevant assets and not just the money supply--is an aspect of the process by which a monetary policy of tightness works. And a rebuilding of liquidity is an aspect of monetary easing.

Sometimes, this rebuilding may take the form of demand deposits and money supply; more often than not, however, it may take the form of time deposits. At other times, repayment of debt may be the most prominent form. And usually all this is going on simultaneously.

The point is: money is only one form of asset, one form in a spectrum of liquidity alternatives, and the amount outstanding will vary over the short-run and long-run in response to shifting public preferences for one asset as compared with another. Money, therefore, is not a unique indicator of monetary policy, nor a reliable guide in itself for policy. It is one among the many monetary variables to be evaluated in the context of over-all financial and credit conditions appropriate to a satisfactory economy.

Let me illustrate all this with the experience of 1967 and the first half of 1968.

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Rebuilding Liquidity and Easing of Credit Markets: First Half of 1967

Events tumble one after another with such frequency in today's world that calendar time itself appears to be accelerating. So when I talk to you about the first half of 1967, which I propose to do for a few minutes, you may feel that environment remote in your recollection. But what I am doing is reaching back to a period when the economy was characterized by a fairly determined effort by all sectors to rebuild liquidity. An important aspect of the demand for liquidity was a 6-1/2 per cent annual rate of expansion in the money supply--a growth rate above what the economy had been accustomed to, or demanded, in the preceding years of the 1960's.

This demand was, it would appear, a direct consequence of the tightening of monetary policy that began at the end of 1965 and culminated in the summer and early fall of 1966. At its culmination, market interest rates were high relative to maximum rates of interest payable by banks and other savings institutions on time and savings accounts or shares; and as a result these institutions were able to attract only a rapidly diminishing share of the public's saving. For example, in the second half of 1966, banks supplied no more than about 15 per cent of the country's credit, whereas under less stringent conditions in the 1960's they had supplied anywhere from 25 to 40 per cent. And the share of credit supplied by nonbank depository institutions also dropped below normal in the period.

The mortgage market was particularly hard pressed by the reduced availability of funds from savings institutions. And

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construction began to drop off sharply, even though these institutions dipped deeply into their liquidity positions to keep mortgage commitments from falling even further. And borrowers who relied on banks found funds increasingly less accessible and more costly. This includes State and local governments, as well as business and consumers, for banks are important buyers of State and local government bond issues. Under the circumstances, both borrowers and banks reduced their liquidity to accommodate at least part of the financing demands.

In the process, during the last half of 1966 the money supply did not grow. If the monetary authorities had thrown even more reserves into the banking system at that time, so that credit had been more available and interest rates lower, it is likely that the money supply would have grown since the public would have felt less need to squeeze its liquidity. But then the inflationary demands associated with the military build-up in Vietnam would not have been dampened. The annual rate of price increase (measured by the GNP deflator) had been between 3 and a little over 3-1/2 per cent since during 1966, and by the first half of 1967 this dropped to about a 2-1/2 per cent annual rate.

The slowing of price rises in the first half of 1967 was accompanied by a considerable slowing in the rate of expansion in over-all economic activity. But to keep this slowing in growth from tipping into recession it was necessary to accommodate the

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sharp rise in liquidity demands during the period. Thus the rapid money supply growth I mentioned earlier.

In addition to money growth, and probably more significant for conditions in the first half of 1967, there was an 18 per cent annual rate of growth in time and savings deposits of banks and an approximately 10 per cent growth in shares and accounts at mutual savings banks and savings and loan associations--all sharply higher than in 1966. As a result banks were able to advance about half of the credit raised in the economy, and other savings institutions about one-quarter. The important fact is that the growth in savings at institutions enabled them to rebuild liquidity, and enabled the nonbank savings institution to make mortgage money much more readily available--which led to increased construction expenditures and helped forestall recessionary tendencies in the economy.

At the same time--with lower short-term market interest rates--consumers and businesses were also able and willing to hold more deposit-type claims. Businesses took the opportunity to restructure their balance sheet position. They not only added to liquid asset holdings by investing in negotiable time certificates of deposit once banks were put in a position again to offer them competitively, but businesses also issued long-term bonds in sharply increasing volume. This tendency continued throughout last year, as corporations, partly in reaction to the tight money squeeze of 1966, made efforts to restructure their debt--that is, obtained more long-term funds so as in some degree to reduce their dependence on short-term borrowing in case money once again became tight.

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Thus, we had in the first half of 1967, rapid growth in money, even more rapid growth in interest-bearing claims on banks and other financial institutions, declines in short-term interest rates, and, for a time, reductions in long-term interest rates--all manifestations of monetary ease. But long-term yields began to rise, and rose sharply, after the early months of the year, and by early summer yields on corporate and U.S. Government securities were above their peaks at the height of the 1966 period of tightness. Monetary variables began to give conflicting signals.

Financial conditions reflected the interaction of institutional demands for liquidity, borrower expectations about future interest rates, and credit demands being generated by the then comparatively sluggish economic growth. The suitability of the financial conditions to the future economy could not be read from the money supply itself--which reflected liquidity demands; or from movements in long-term interest rates--which had a strong expectational component; or from the declines in short-term market interest rates alone--since they in part reflected the Treasury's ability to repay debt in the spring. Whether financial conditions were suitable had to be read from the future course of economic activity. And as the first half of 1967 progressed, it became apparent that the real rate of economic growth would be picking up soon and that there were evident dangers of a resurgence of inflationary pressures.

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Tightening of Credit Markets: Second Half of 1967 and First Half of 1968

Thus, it became more and more apparent in the second half of 1967 that public policy action was required to keep the economy from overheating. With no one sector of the private economy appearing to be the unique source of potential excess demand pressures, and with Government spending continuing to rise fairly sharply, most economic analysts agreed on the need for additional fiscal restraint--through tax increases that would moderate private spending across the board and through reduced Government spending. But while fiscal restraint was developing, it was apparent that financial markets needed to become less conducive to greater spending.

The Federal Reserve contributed to that end basically by holding back on the funds it made available to the economy, and making them most costly, relative to the total demands for credit that were developing in the economy. The evidence of such a policy is to be seen from the following financial relationships: (1) net funds raised in all credit markets during the one year period ending with the second quarter of 1968, including large U.S. Government credit demands stemming from the sizable budgetary deficits, amounted to over $95 billion, as compared with only about $60 billion (seasonally adjusted annual rate) in the first half of 1967; (2) at the same time, growth in the total reserves of the banking system slowed to about a 7 per cent rate from a 10-1/2 per cent annual rate in the first half of 1967, and these reserves are the means by which the Federal Reserve can inject

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funds into or remove them from the economy; (3) the cost of obtaining credit from the Federal Reserve rose from 4 per cent to 5-1/2 per cent; and (4) the maximum rate of interest that could be offered on interest-bearing deposit accounts by banks and other savings institutions limited their ability--as market interest rates and credit demands rose--to attract funds that could be channeled to borrowers.

You can see that credit demands grew, but that the availability of funds from the Federal Reserve slowed and their cost became higher. The interaction of such demand and supply conditions led to a sharp rise of interest rates, but with the extent of rise partly influenced by market fears during much of the time that measures of fiscal restraint would not be finally enacted. Short-term market interest rates rose throughout the period from mid-1967 through mid-1968, with the 3-month Treasury bill rate rising about 2-1/2 percentage points to a high of almost 6 per cent, a level somewhat above the 1966 peak rate. And long-term rates rose further to levels well above the 1966 peaks.

The rate of expansion in money supply during this period did not, however, slow down significantly. In the second half of 1967, money grew at about a 6 per cent annual rate, and in the first half of 1968 at a 6-1/2 per cent annual rate, not much changed from the first half of 1967. Since around mid-1968, the

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money supply outstanding has shown little net change, partly because the rate of economic expansion and associated transactions demands have moderated, and also perhaps because liquidity priorities have become less urgent.

The maintenance of money growth in the first half of 1968 when monetary policy was tightening seems attributable to a growing transactions demand for cash, and to an unwillingness on the part of businesses and consumers sharply to reduce their liquidity given their experience of the recent past. The transactions demand is shown by the rise in the economy's real rate of growth to an almost 4 per cent annual rate in the second half of 1967 and to a very rapid 6-1/2 per cent rate in the first half of 1968, and by the 10 per cent rise in the deposit turnover rate compared to little change in the previous year. In addition, there appeared to be some expansion in demands for cash related to financial transactions, with stock market volume expanding quite sharply in the spring of 1968.

While the bite of tighter monetary policy cannot be measured directly by the money supply, it was clearly felt by financial institutions. Commercial banks became increasingly less able to compete for time and savings deposits as market interest rates rose. By the first half of 1968 they could supply only about one-fifth of the funds advanced in credit markets. Other savings institutions, too, found it increasingly difficult to attract funds that they could lend. And capital market investors

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became less willing to place funds in new bond issues. So, all in all, it became more difficult and expensive for State and local governments, consumers, builders, and other businesses to borrow.

While it seems clear that monetary policy became tighter--the money supply notwithstanding--whether policy, however, defined, was tight enough is less easily answered. Critics will point to the acceleration of price increases to a 4 per cent annual rate, and to a continued balance of payments deficit. But price pressures are in part both a reflection and a cause of wage pressures, and the latter were quite strong during the past year. And the timing of fiscal policy in relation to monetary policy--the question of the policy mix--will continue to be a matter of discussion, as will the question of how pervasive an influence on the economy does monetary policy have, or can reasonably be expected to have.

While this brief review of recent developments did not go into such issues, I hope that some perspective has been provided on the question of how best to measure, or guide, monetary policy. Let me, at any rate, conclude by attempting to weave some of the strands together.

Concluding Comment

(1) Monetary policy cannot be gauged simply by whether interest rates are higher or lower than at some other time, or whether bank credit and money supply are rising faster or slower. It has to be evaluated by whether existing and past financial

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conditions are leading to a satisfactory economic performance. And it will turn out that a satisfactory economic performance--one in which the economy is at a high level of economic activity with reasonable stability in prices--will be consistent, at different time periods, with varying rates of growth in money or other liquid assets, with varying flows of credit through financial institutions, and with varying levels of interest rates. It will depend on the asset preferences of the public, their liquidity needs, the level and composition of credit demands, and the state of market expectations. This being so, no single financial measure is an adequate guide for, or indicator of, monetary policy.

(2) The measures of monetary policy will also depend on institutional changes in the economy. Changes in maximum rates of interest payable by banks and savings institutions will obviously affect the demand for money and the level of market interest rates consistent with full employment. The increased flexibility in competing for savings, and improved liquidity position, of savings institutions, were, for instance, factors that enabled market interest rates to rise as much as they did during the monetary restraint of the first half of 1968.

(3) While all financial variables reflect the interaction of monetary policy and the public's credit demands and asset preferences, certain variables at times are more crucial than others. But these are not necessarily those most directly controlled, or affected,

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by monetary policy. If, for instance, the central bank holds back on total reserves so as to reduce growth in member bank assets, and perhaps even in money supply, there will be extensive ramifications in other markets as the public seeks to satisfy its demands in ways other than through banks. The key variable would then be, not the one through which monetary policy acts (i.e., bank reserves), but the one which has the most significant link to spending. In 1966, for example, it turned out to be the mortgage market, given institutional factors at the time.

(4) Thus, it is the financial links to spending that are most critical. And in that respect economists have left us little choice but to evaluate the whole range of financial conditions, since the number of links appears fairly large--and may only be limited by the number of economists searching for links. But the search needs to go on, for it will not be until we fully understand the relation between financial variables and spending that we can with real assurance say monetary policy is easy enough or tight enough.

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