Not a press release

National Monetary Policy in An International Setting

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at the

CENTO Symposium on Central Banking,
Monetary Policy and Economic Development

Izmir, Turkey

April 5-12, 1971

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Our concern at this Symposium is to consider the particular contributions the central bank can make to national economic objectives. At the outset, we must recognize the differences in monetary management between the United States, the other industrial countries and the less developed countries. These differences necessarily limit the extent to which our experiences can be regarded as interchangeable. Yet they should not obscure the similarities which central bankers find when they talk shop among themselves.

Central bankers in all countries find that the role and tools of monetary policy are always changing as national priorities and the financial and economic environments are altered and as their understanding of monetary linkages evolves. Furthermore, they share with each other the recognition that all central bankers must operate at home within their particular authority and capabilities. For they have to recognize the limits of their effectiveness, both in terms of the technical effectiveness of the instruments of credit control and in terms of the distribution of political power and responsibility within the nation.

Our topic is particularly timely in that our Turkish hosts have recently expanded the responsibilities and powers of their central bank in the field of money and credit policy. The new powers include: the setting of cash reserve requirements;

rediscount of medium-term paper; extension of medium-term advances; and authority to conduct open-market operations. They have also introduced a governorship type of organization to replace the "general directorate" formerly in effect. I gather that the monetary authorities are hoping to make use of open-market operations when a capital-market bill, now under consideration at the Ministry of Finance, is approved. I am certain that all of us will be interested in discussing these changes in Turkish banking at this conference and that all of you join me in applauding this important decision and in wishing officials of the central bank well as they face their new responsibilities.

Evolving Central Bank Techniques

The kinds of problems our Turkish friends will be facing are the central issues before our Symposium. The effectiveness of central banking operations can always be improved. In the United States, for example, we have a central bank established nearly 60 years ago; but we are in a constant state of flux so far as operating techniques are concerned. We have just completed a broad-based study of our discount mechanism and the end-product of our three years of study is likely to be the most sweeping changes in the structure and administration of our discount window in the history of the Federal Reserve System.

Let me mention three other technical innovations already well-developed, or evolving, which have or probably will materially alter the way the central banking system functions in the United States. We are attempting to construct econometric models of how the U.S. economy functions with a sufficiently developed financial sector to enable us to observe the linkages from Federal Reserve actions to their effects on final spending. In addition, we have now developed a flow-of-fund analysis which enables us to observe the sources of financial flows and their ultimate uses within the context of a matrix which imposes the constraint that sources and uses must balance. As a final example, we have begun to make use of projections of a complex of monetary variables in trying to choose between alternative courses of monetary action. None of these techniques were available to us 10 years ago.

Central banks are also concerned about the establishment of financial institutions and the formulation within each country of policies and programs to accelerate economic growth within the constraints of a reasonable degree of price stability and external balance. These are broad and difficult goals to attain and we always have to ask ourselves as we look back over the recent past: what lessons can we learn from our experience and from the experiences of other countries about the effectiveness of monetary policy in controlling aggregate demand?

As I thought about recent monetary developments in the United States, it became more and more evident that our experience might be relevant to the less-developed, as they are to the developed, countries. Let me discuss with you recent developments in the United States which seem to be appropriate to the major themes of this conference.

Monetary Policy and Aggregate Demand

Our big challenge in the United States, like the one each of you faces in your country, has centered on the role of monetary policy in controlling aggregate demand and economic growth. The way inflation has become so wide-spread and persistent in recent years demonstrates that all of us, developed and developing countries alike, have much to learn. In 1970, for example, the GNP price deflator advanced at a rate of about 5 per cent on the average for the 17 OECD countries covered in the recent OECD report on Inflation. We have been experiencing anew in the United States the stubbornness of the price-wage spiral as we come out of a period of pervasive excess demand and are confronted with the social costs of the differential wage and income shifts which developed in a strong inflationary surge.

Because we have been having more inflation than the U.S. public is willing to accept, there has developed a determination that U.S. demand-management policies be more effective during the 1970's than they were during the past five years. This determination

to improve future performance has led to significant changes in three areas of central banking in our country:

a. Greater use of monetary and credit aggregates as a monetary guide or indicator;

b. The introduction of techniques to regulate credit flows to specific areas instead of continuing to depend wholly on allocation through market processes; and

c. The search for monetary techniques to make monetary policy effective in an increasingly interdependent world where the balance of payments and international movements of capital and goods threaten national monetary management.

Let me discuss each of these points.

Monetary Aggregates and Monetary Policy

During 1970, there was somewhat more emphasis on the behavior of monetary aggregates, especially money supply and bank credit, as a key variable in the fashioning of day-to-day monetary policy in the United States. This greater emphasis has been the subject of widespread discussion and it may be helpful if I try to interpret the changes which have taken place in terms of the techniques of central banking familiar to all of you.

From an historical point of view, beginning with the Treasury-Federal Reserve Accord in 1951, there has been in the United States an emphasis on money-market conditions--at one time called "tone and feel of the market"--as a key guide to Federal Reserve open-market operations. Even though the various money market indicators have shifted in significance, the

objectives of central-bank operations have been concerned with such elements of the money market as (a) member bank excess reserves and their borrowings at the central bank, and (b) the interest rate on Federal funds, and short-dated certificates of deposit, Treasury securities and other money market instruments. In 1966, the Federal Open Market Committee introduced, as a supplementary indicator, certain monetary aggregates--first, bank credit and, later, the money supply.

The important change during 1970 was to give a more prominent role than heretofore to financial aggregates--that is, M_1 and M_2 and total bank credit--along with interest rates and money-market conditions in defining the immediate targets of monetary policy. Monetary conditions, so viewed, are a complex of money and credit flows, a broad spectrum of long and short-term interest rates and the environment of money market conditions, both subjective as well as measurable.

This greater emphasis upon measures of monetary growth does not represent a commitment to a monetarist theory of central banking nor a radical change in the theories underlying central banking in the United States. I, for one, would seek the effects of monetary actions through changes in liquidity and in wealth and would regard the narrowly-defined money supply not as a causal force in itself nor even a monetary North Star, but as a generally useful proxy. Since my fellow members of the Federal

Reserve Board would have their own concept of linkage, this change in emphasis is consistent with several distinct economic theories as well as a certain amount of agnosticism.

Moreover, the greater emphasis on measures of monetary growth has not diminished the need to protect U.S. financial markets from unexpected disturbances. Last spring, for example, the Federal Reserve found it necessary to protect U.S. financial markets when they became unsettled as a result of the bankruptcy of a major railroad. In this situation the central bank shifted attention, for a time, from monetary aggregates. It reminded member banks that the System's discount facilities were available to restore liquidity on a scale and for a period appropriate to the prevailing environment and it gave first priority to evidence that unexpected shifts in the public's demand for cash and liquidity were being adequately met regardless of the immediate impact on rates of growth in the aggregates.

The lesson we have been learning from recent experience, as I see it, is that no single monetary guide can serve the needs of policy day in and day out. Unfamiliar environmental conditions have unique and unpredictable effects on the timing of changes in expectations for liquidity and credit markets. At times policy should take account of such uncertainties by changing focus from one aggregate to another or from some aggregate to money market conditions, or to some segment of the interest rate structure. Our knowledge, at present, is insufficient to orchestrate monetary policy with but a single guide or a single tool.

Greater Flexibility in Interest Rates

As you know, interest rates in U.S. financial markets in the late Sixties responded to unprecedented demand for capital and to inflationary expectations by reaching very high levels--among the highest in our history. This experience reminds us that a realistic interest-rate policy is an integral part of sound monetary management in any country. Only by permitting such rates to respond to underlying economic realities can we expect interest rates to contribute to economic growth by providing (a) a real incentive to attract private savings; and (b) a rational guide for computing costs in the allocation of national resources.

The recent fluctuations in interest rates among the industrial countries have tended to encourage international capital flows in response to temporary differentials in yields. These capital movements appear to have had important, even if they were only temporary, effects on the international reserves of the leading trading countries and to have limited even further the capability of their central banks to manage their monetary policy primarily on the basis of domestic economic considerations. This situation is likely to persist and seems certain also to affect the central banks of the less-developed countries. It is also likely that residents in the less-developed countries will find themselves affected by the interest-rate variations in the Euro-dollar and in other principal financial markets, both as lenders and borrowers.

In the years ahead, therefore, countries which do not wish to see domestic savings flowing abroad in response to higher interest rates may have to restrain such flows directly or tolerate higher interest rates at home than they otherwise might like to see.

Outflows can, if necessary, be restrained by specific taxation on foreign investment--such as our interest equalization tax--or by agreements such as are incorporated into our foreign investment restraint program. While in the long run the world economy and international borrowers and lenders have much to gain from the free flow of funds we do not yet live in one financial world where unlimited flows of this type can be accommodated. The strategy that works for the capital-short countries is to time their borrowing when both interest rates and sensitivity to outflows of funds are relatively low in the lending countries.

Non-Market Devices to Encourage Credit Flows into Priority Uses

The second point I want to stress is our experience with attempts to divert or focus the onus of monetary restraint on certain sectors of the economy.

The dilution of restraint was chiefly undertaken for the benefit of the housing sector of the economy. Because the home construction industry experienced a disproportionate impact of credit restraint in 1966, the U.S. Congress enacted various measures to cushion such adverse effects during the credit stringencies of 1968-69.

We were able to improve credit flows into housing in several ways. Mainly, Government housing agencies used the public credit to borrow funds in financial markets and make them available to the mortgage-lending industry, at times at below market (that is, subsidized) costs. In addition, the financial intermediaries which provide the largest share of housing credit were protected against the greater adaptability of the commercial banks' portfolios to rising interest rates by Government regulations which set maximum rates each type of institution could pay.

These and other regulatory policies were also aimed at placing more of the burden of restraint on the banking system and its customers. This was done with rate ceilings, regulations curbing banks' ability to substitute other liabilities for deposits, and restrictions on contingent sales of assets. In total, these measures limited the banking system's ability to lend to its customers, a fact that is abundantly clear from the magnitude of the decline in market shares of funds going to banks in 1966 and 1969. The same rate ceilings also hampered the savings and loan associations and the mutual savings banks in serving their customers, although their plight in 1969 was ameliorated by the operations of FNMA and the lending policies of the FHLB Board.

As seen by their proponents, regulatory constraints, limiting bank access to funds, led to greater restraint on

business loans than would otherwise have occurred--a desirable distributional effect on credit availability in view of the role of business investment at that time in generating excess demand and inflation. Furthermore, since intermediaries are more efficient in their credit allocative function than direct lenders and markets, the reduction of intermediation is seen as the quickest and surest way to slow and restrict the availability of credit and thus to bring about the modification of spending and investment decisions. All of those borrowers who are exclusively dependent on intermediaries encounter credit restraint even though they may be preferred customers.

The main argument against sealing off the banks and other intermediaries from markets is that the effectiveness of over-all restraint is not significantly diluted as a result of its being shifted by a bank intermediary to the market or another intermediary, however different the incidence. As banks disperse monetary restraint, and they cannot disperse all of it, they force borrowers other than their customers to pay higher prices for credit and to face uncertain availability. Their action in selling assets, raising interest rates paid for funds, entering into repurchase agreements of assets and the like, does not result in much diminution of over-all restraint. Even if intermediaries were given unlimited access to money and credit markets they would themselves be in-

creasingly restrained by the market environment they would be creating. The argument continues that the channeling and confinement of restraint to intermediaries and their customers results in the unnecessary dislocation of credit patterns, in inequities in the distribution of credit and inefficiencies in the operation of the financial system.

The differential effect of forcing intermediaries to contract their lending operations has the most certain and serious effect on smaller customers who do not have significant access to capital and credit markets. Shutting off or restricting the flow of bank credit to large corporate borrowers only means they become more dependent on markets. And since such borrowers are better able than most others to obtain funds in the market using such non-depository credit instruments as commercial paper, some have argued that corporate borrowers were more favorably situated with respect to credit availability as a result of bank disintermediation.

While I am persuaded that intermediaries should have had more ready access to markets, the contrary position is not without merit from a pragmatic short-run standpoint. However, I believe the real problem is not one of making monetary and credit restraint effective in some given interval but the longer run effect of such tactics on the process of intermediation and the institutions providing this service.

In recent years our Congress has considered, without taking action, several proposals that the Federal Reserve actively deal in and support the market for securities related to such high priority social investment as housing. At present, and historically, the Federal Reserve's portfolio has almost exclusively been invested in Treasury issues. At the end of February this year, for example, Treasury issues totaled $62.5 billion out of some $64.0 billion of earning assets held by the System. The weight of precedent, a continuing concern for a strong Government security market, and uncertainty as to the manageability of a portfolio oriented toward goals in potential conflict with monetary objectives has deterred policy makers in the U.S. from seeking or endorsing such diversification. So far as I can see the issue is not of principle or theory but a pragmatic judgment as to how surely social investment objectives can be realistically confined.

Experience in the LDC's

Perhaps you will agree that the central banks have gone further in the developing countries to accommodate special credit needs than have those in the developed countries. In the LDC's, the central bank often gives rediscounts and advances to favored sectors or priority activities in preference to other credit claimants. This need to channel credit flows into priority areas

which will spur economic development and away from less socially preferred channels--an excessive building of luxury housing, for example--may pose difficult choices for the central banker; for he should, to meet stability objectives, be able to limit flows of funds to favored sectors to amounts within a monetary constraint.

Many central banks also use a variety of policy measures with a selective impact in order to encourage the commercial banks to allocate credit along certain lines. Just last week, Chairman Burns testified before a Senate subcommittee on a proposal to establish differential reserve requirements on assets of commercial banks with a view to effecting the allocation of credit.[1/] Such guidelines to commercial banks are known to have practical shortcomings but there are a number of countries in which this approach to credit-channeling appears to have altered the pattern of domestic credit flows. In fact, I think all of us should acknowledge that many central bankers in the developing countries have been able to achieve results in this area--both in devising ways to provide additional flows of local capital for economic growth and in orienting them toward high social priority uses. On the other hand, central banks in Europe have been moving away from the use of such selective devices.

1/ See Appendix for a portion of Chairman Burns' statement.

Monetary Management in an Integrated World Economy

Finally, we have also learned in the United States how substantially national monetary management is linked to developments in the international economy. Any of us may have to be reminded that balance-of-payments considerations may set limits to the use of credit policies for the domestic goals of economic stabilization; but we all recognize how important sound international economic relations are to domestic stabilization and growth.

In the United States, the expansion of multi-national corporations and of financial institutions has raised new problems affecting the U.S. banking structure and monetary management. These corporations and international financial institutions have embarked on overseas expansion on a scale which has taxed the capacity of the U.S. payments position. As a result, the U.S. authorities have taken steps to ensure that a greater proportion of these investments be financed from savings outside the United States. As you know, the U.S. programs on capital flows and on bank lending abroad have been designed not to limit U.S. direct investment abroad but to ensure that the projects be financed abroad. Under them, however, provisions have been made to accord the LDC's a special access to U.S. financial markets.

Both the U.S. and the host country have an interest in the financial decisions of the multi-national corporation and the international financial institution. In general, we can agree, these activities are least likely to disturb domestic policies if the transactions are done in the country or currency in which the expenditure is to be made. Similarly, there are times of relative credit ease when it is a matter of indifference how such transactions are carried out. There are also times of strain in the domestic economy or in the balance of payments when capital and credit shifts impose an important challenge to the capabilities of the authorities to achieve national economic objectives.

There are also situations where U.S. corporations have been thought to borrow excessive amounts from local banks. In some countries, these credit demands have been thought (rightly or wrongly) by local businessmen to have impaired their own access to local bank credit. On these grounds, some developing countries have adopted measures to limit the credit which local banks may extend to branches and subsidiaries of foreign business firms.

U.S. Banks Follow Customers Abroad

It was a natural result, I think, that U.S. banks have followed their business customers abroad. As a result, we have witnessed over the past decade a large expansion in U.S. banking overseas.

In general, the Federal Reserve has expected that U.S. banks would function overseas in accordance with local standards and regulations and that they would serve to mobilize local resources for their business financing. A few developing countries have restricted the activities of foreign banks and/or have required them to bring in substantial amounts of equity capital. When foreign banks penetrated a developing country by buying an interest in an existing bank, this has at times produced a reaction from local business firms whose access to credit might, or would possibly, have been impaired. A few countries have prohibited the sale of stock in existing banks to foreign interests.

On the other hand, I am not sure that the contribution of U.S. banks to the economies of LDC's is fully appreciated. They not only have helped their American customers to meet their financing needs in the particular country but have extended their services as financial intermediaries to non-U.S. residents. In this capacity, they have offered them attractive yields in local-currency and even in dollar-denominated assets, greater liquidity and perhaps greater security for their savings as well. U.S. banks have also often introduced an element of competition which has benefited both local borrowers and local lenders. They have also made available U.S. financial expertise and technology in business and consumer financing. Local businessmen have been

introduced to new ways of obtaining working capital which were often more flexible or more readily adaptable to their business requirements than were the traditional forms of bank finance available to them.

The U.S. and other foreign banks in the LDC's have also been a link between local financial markets and the broadly-based international markets which have developed outside the United States for dollar-denominated deposits and long-term placements. The flow of private and official savings from this Near East area and from other developing areas into Euro-dollar markets for deposits and long-term securities demonstrates that non-U.S. residents have found these facilities attractive.

Such a flow, of course, represents the reverse of what most of us would prefer because it represents loans by the less-developed countries to the industrial countries. As such, this flow of capital will aggravate the already serious shortages of capital in the developing countries and place added burdens upon the monetary authorities there. It challenges them to create financial institutions, a type of intermediation, and a pattern of incentives attractive enough to encourage the local placement of these savings.

More broadly, the answer to this problem may lie in developing new opportunities for employment of domestic savings

within the developing countries and in providing an environment in which the risks of capital loss from inflation and devaluation, or from expropriation, are at a minimum.

Keynote

National financial problems often appear on the surface to differ greatly as between less-developed and developed countries, or even from country to country within each group. But the need to pursue domestic stabilization programs to promote sustained national economic growth is a challenge common to the monetary officials of both developed and less-developed countries.

In both, the central bank can make its contribution effective only if its potential and limitations are understood and only as it brings its techniques and its monetary actions into line with changing conditions in the national economy. The central bank to be successful needs financial markets, banks, and other local financial intermediaries through which it can make its policies operational.

Each of us has had a varied and specialized experience in matters of monetary management. This Conference will fulfill its purpose when our discussions over the next five days remind us how much we can profit from each other's experience and lead us to recognize how unique are the contributions of skill and continuity which the central bank can make to the national economic effort in each of our countries, developed and less-developed alike.

APPENDIX

Excerpts from the testimony of Chairman Burns on March 31, 1971, before the Subcommittee on Financial Institutions of the Committee on Banking, Housing and Urban Affairs of the U.S. Senate

Finally, Section 4 of S. 1201 would authorize the Board to require banks that are members of the Federal Reserve System to maintain supplemental reserves against assets, in addition to the reserves they must now maintain against depositary liabilities.

The purpose of the supplemental reserve requirements would be to facilitate flows of credit into specified channels and restrain flows into sectors where, in the Board's judgment, such restraint would "help stabilize the national economy." The Board unanimously recommends against enactment of this section of the bill at the present time.

All of us agree, I am sure, on the need to explore ways to avoid unwanted selective effects of general monetary restraint. But use of reserve requirements for this purpose poses problems for which we do not yet have answers. Much further study is needed.

Another shortcoming of supplementary reserve requirements is that they would complicate the already intricate task of the Federal Reserve System in discharging the main responsibility assigned to it by the Congress--namely, to conduct monetary policy so as to promote prosperity while protecting the integrity of the nation's money. Once supplementary reserve requirements came into use, shifts in the level of required reserves would result from every shift in the lending policies of commercial banks. As required reserves rose or fell, funds for expansion of bank credit would be absorbed or released. These movements would introduce an additional element of uncertainty into the task of achieving, through open-market operations, a desired rate of growth in the money supply or in bank credit.

Even if these operational difficulties could be overcome, there would still be fundamental objections to this section of the bill. I trust you will consider most carefully the implications of granting the central bank the vast discretionary authority contained in this bill to determine social priorities in the use of credit. The Federal Reserve System has the critically important assignment of providing for aggregate supplies of money and credit needed to

promote healthy economic growth with reasonable price stability. Congress has granted the System a considerable measure of independence, to ensure that it will be insulated from short-run political pressures in performing this function. We believe there is great value to our society in this arrangement, and that its continuance depends on confining the discretion of the central bank, in the main, to matters of general monetary policy.

S. 1201 authorizes the Board to establish supplementary reserve requirements to facilitate flows of credit into housing, small businesses, exports, municipal finance, farms with sales of less than $100,000 a year, and development of areas of low income or high unemployment. Increasing credit flows for these purposes implies reducing them for others--relatively, if not absolutely. The implications of such a wide-ranging substitution of public for private decisions need to be considered with utmost care.

Our free credit markets have served our nation well over the years by channeling financial resources to productive and socially beneficial uses. The Board recognizes, nevertheless, that market mechanisms are imperfect and that the effects of monetary ease or restraint do not affect all sectors of the economy uniformly. There is ample justification, therefore, for serious efforts to improve the functioning of our financial markets--particularly, to cushion the effects of monetary restraint on sectors such as housing.

Such efforts have been made on an extensive scale in our country, and they have typically taken the form of supplementing the market mechanism rather than subjecting the decision-making process of private financial institutions to detailed and shifting governmental rules. Federally sponsored credit agencies that borrow funds in the money and capital markets and channel them to sectors of high social priority have played a particularly constructive role in this regard. So also have government loan guarantees to encourage private investment in risk enterprises or in low- and middle-income housing.

For most of the specific sectors singled out for special attention in S. 1201, special credit facilities already exist. The nation's home building industry, for example, is provided special assistance, particularly in periods of monetary restraint, by the Federal Home Loan Banks, FNMA, GNMA, and through a variety of programs operated by the Department of Housing and Urban Development; small firms are aided in securing credit by the Small Business Administration; the nation's farmers are assisted by the Farmers Home Administration and the several lending

agencies of the cooperative Farm Credit System. These agencies have performed a vital service in improving the functioning of financial markets. If the Congress should conclude that the sectors singled out for special attention in S. 1201 deserve more ready access to sources of credit, certainly the most direct and probably also the best means of accomplishing this objective would be to expand the scope of operations of existing Federal credit agencies in these fields, and to create new entities where they seem needed.

However, if after due deliberation the Congress were to decide that supplementary reserve requirements on assets of banks are to play some role in redistributing fund flows in financial markets, we would strongly urge that the order and degree of priorities should be determined by the Congress and embodied in legislation. Broad discretionary authority of this kind should not be lodged in the Federal Reserve, which is not the appropriate body to make fundamental decisions regarding social priorities.

It may be useful to note that the trend over the past 10 years or more in central banks of other industrial countries has been <u>away</u> from practices that discriminate in favor of particular sectors and <u>toward</u> policy instruments that have broad application and generalized effects.