A REVIEW OF CREDIT AND MONETARY POLICY

by

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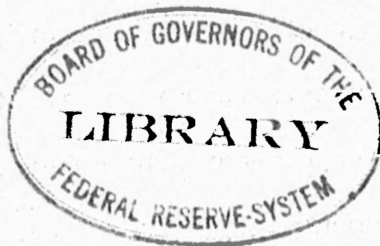

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Today let me discuss with you the general question of money and credit as I see it.

As you know, the Federal Reserve is concerned with influencing the volume of credit and money. This influence is brought about primarily by affecting the reserve position of the banking system. By adapting credit and monetary policy to the needs of the economy, the Federal Reserve strives to make the maximum possible contribution to stable economic growth.

You have all observed the effects of changing credit and monetary policies on the positions of commercial banks. When policy becomes restrictive, more banks will be in debt to the Federal Reserve Banks, bank holdings of short-term securities will generally be reduced, and the market values of long-term securities will be depreciated. All of these developments tend to restrict the willingness of banks to expand credit. When credit and monetary policy becomes easier, the opposite developments will take place.

Although Federal Reserve credit and monetary policy operates through its influence on bank positions, these are only the initial effects. Not only do Federal Reserve actions affect the terms on which banks lend and invest, but indirectly they also affect the terms on which nonbank investors lend and invest. This influence results from the highly developed character of the market for money and credit and the fact that both banks and nonbank investors operate in many segments of this market. For example, if banks are selling Government

securities, or reducing their purchases, prices of these securities will decline. Other investors will therefore become more willing to buy and less willing to sell. Lower prices and higher yields on Government securities thus tend to restrict lending to other borrowers.

As you well know, the Federal Reserve has three major ways of influencing bank reserve positions. One is open market operations in United States Government securities and bankers' acceptances. A second is changes in percentage reserve requirements. A third is regulation of the discount mechanism through which the Federal Reserve Banks lend to member banks; this includes changes in the discount rate. In recent years all of these instruments have been used flexibly to influence bank reserve positions.

As you will recall, in early postwar years the use of open market operations to affect bank reserve positions was hampered by the policy of supporting the Government security market. Securities were purchased by the Federal Reserve in order to peg Government security prices, and increases in reserve requirements were sometimes used to offset the effect of such purchases. Because reserves were readily obtainable through sales of securities, the discount mechanism was largely inoperative.

Let me therefore repeat here what has often been said before, that since the Treasury-Federal Reserve Accord early in 1951 open market operations have been carried on primarily with regard to their effect on bank reserve positions. Meanwhile, the role of the discount mechanism has increased in importance.

The use of the various instruments of credit and monetary action has been adapted to prevailing economic conditions, and some-

times two or more of the instruments have been used together to bring about the desired results. The Federal Reserve has studied carefully the operations of the various instruments in the postwar economic and financial setting, and the experience gained has enabled it to adapt the use of these instruments better to the needs of the banking system.

Open market operations are generally the instrument best adapted to meeting changes in the needs for bank reserves as they develop over time. Typically, reserve needs can best be met by an instrument that can supply or absorb funds in small amounts and that can be reversed if necessary. Open market operations are eminently suited to fill this requirement.

Changes in economic conditions calling for changes in credit policy are usually gradual. At any time the need is not likely to be for a drastic change in bank reserve positions, but rather merely for somewhat tighter or somewhat easier positions. Moreover, at times it is not clear what policy will be called for several months in the future. Open market operations are readily adapted to meet these circumstances, since purchases or sales can be in any amount and they can be readily reversed if necessary.

Open market operations are also used to meet changing reserve needs associated with many developments other than changes in general credit and monetary policy, and such operations in any period must be interpreted with regard to these developments. For example, a gold inflow associated with a surplus in our international balance may supply banks with reserves while a gold outflow may deprive them of reserves. Temporary changes in the Treasury balances at the Reserve

Banks also affect bank reserve positions. Open market operations may be used to offset these developments. In addition, the Federal Reserve typically purchases securities in the second half of the calendar year and sells them in the first half in response to seasonal changes in the demand for currency and credit. Finally, the needs of a growing economy require an increase in deposits and reserves from year to year.

From time to time the Federal Reserve also purchases U. S. Government securities from dealers and brokers under repurchase agreements. According to the terms of these agreements, the dealers and brokers agree to repurchase the securities at a fixed price, usually within a matter of a few days. Repurchase agreements have been found extremely useful to supply bank reserves to the market at times of temporary shortages for technical reasons. For example, there are frequently special needs for reserves near the end of the year when banks are unwilling to show indebtedness on the December 31 balance sheets.

At times <u>changes in reserve requirements</u> have been used to provide banks with reserve funds or to absorb such funds. This instrument can best be used when banks are faced with a large and long-run change in their need for reserves. By its very nature, this instrument is not ordinarily suited to meeting gradual and short-run changes in reserve needs.

Reference thus far has been to the ways in which reserves are supplied or absorbed at the initiative of the Federal Reserve. Member banks can also obtain reserves at their own initiative by borrowing from their Reserve Banks. Regulation of the <u>discount mechanism</u> is the third way in which the Federal Reserve can affect bank reserve

positions. Discounting tends to increase when open market and reserve requirement actions of the Federal Reserve become more restrictive. Since banks do not like to remain in debt, an increase in member bank borrowing tends to restrict bank credit expansion. In addition, when a more restrictive credit policy is being followed, the Federal Reserve Banks generally raise their discount rates, thus making borrowing more expensive. It is therefore evident that when Federal Reserve policy eases, member bank indebtedness declines and excess reserves may increase, thus encouraging bank credit expansion. At such times reductions in Federal Reserve discount rates are customary.

These instruments of credit action have all been utilized in recent years in response to economic developments. Since mid-1952 economic developments have included two periods of rapid expansion in business activity and in the demand for credit as well as a period of moderate business recession.

From mid-1952 until the spring of 1953 Federal Reserve credit and monetary policy was directed toward preventing inflation. At this time there was an increase in the demand for credit stemming from the removal of selective credit controls, optimistic business expectations, growth in inventories, and a Federal deficit. Since the economy was already fully employed, the extent to which production could increase was limited, and it was necessary to take steps to restrict credit expansion. This was done largely by restricting Federal Reserve purchases of securities in the open market. Purchases over this period on balance were more than offset by gold and currency outflows. Member bank discounts exceeded one billion dollars on the average in nearly

every month from July 1952 through April 1953. In January 1953 Federal Reserve Bank discount rates were raised from 1-3/4 to 2 per cent. Despite the strong demand for credit, the rate of growth of bank credit and money declined, and prices remained stable.

By the spring of 1953 it appeared that the existing degree of restriction was no longer necessary, and after the middle of 1953 the demand for credit became less active, particularly for consumer credit and short-term business credit. Beginning in May, the Federal Reserve acted to ease bank reserve positions, and from late 1953 until late 1954 it pursued a policy of active ease. It purchased securities in the open market beginning in May 1953, and in July additional reserves were provided by a reduction in reserve requirements. Although the reserves thus provided were used in part to meet seasonal needs, they permitted a reduction in member bank indebtedness to the Federal Reserve Banks. Discounting declined further early in 1954 despite seasonal sales of securities by the Federal Reserve. Discount rates were reduced from 2 to 1-1/2 per cent in the period from February through May. In the summer of 1954 additional reserves were provided through further reductions in bank reserve requirements. Since these were provided in part in anticipation of seasonal needs, they were partly offset by sales of securities in the open market. As needs developed, the Federal Reserve made reserves available by purchasing securities.

The money supply increased slightly from mid-1953 to mid-1954, in contrast with declines in some earlier business recessions. After mid-1954 it increased sharply, at a seasonally adjusted rate of about 5 per cent per year.

By late 1954 it was clear that a policy of active ease was no longer appropriate for prevailing economic circumstances. There was an increase in the demand for credit, especially consumer credit and short-term business credit, and employment and production increased. The Federal Reserve permitted bank reserve positions to tighten somewhat in late 1954 and early 1955. Although Federal Reserve sales of securities early in 1955 were largely seasonal, bank discounting increased to an average of almost half a billion dollars in the second quarter of 1955. Since midyear the Federal Reserve has permitted bank reserve positions to tighten further, as employment and production have reached record levels, but the demand for credit has continued to grow. Discount rates at the Reserve Banks have been raised from 1-1/2 to 2-1/4 per cent by three separate steps. In addition, the Board of Governors has raised margin requirements for purchasing or carrying securities from 50 to 70 per cent by two separate actions in order to help prevent the excessive use of credit for stock market trading.

It may now be of some interest to compare our credit and monetary policies with those of some other nations. Needless to say there are often differences between other countries and our country in institutional structures as well as in economic and financial conditions. Therefore, we must be extremely cautious if we try to apply our experiences to other countries, or foreign experiences to our own conditions. Nevertheless, it seems to be significant that all over the free world, and especially in Europe, there has been a growing reliance on general credit and monetary policy. Permit me, therefore, briefly to review this development.

You know that ever since the end of the Second World War, most foreign countries have been suffering from inflationary rather than from deflationary pressures. In the early postwar period, these pressures originated primarily from the need for rapid reconstruction of war damaged plant and equipment and depleted inventories; the desire for a rapid restoration of prewar standards of living; and the inability of countries with reduced foreign exchange holdings and impaired productive capacities to pay for the bare minimum of producer and consumer goods imports, either out of their reserves or by increased exports. At that time, anti-inflationary monetary policies were little used. Instead, reliance was placed on direct controls, which aimed at channelling available resources to those uses that the authorities, rather than the individual producer and consumer, believed to be most urgent. The breakdown of the world economy was avoided primarily by large-scale foreign assistance, most of it (though by no means all) from the United States.

These initial pressures had largely disappeared when the outbreak of hostilities in Korea gave inflation a new impetus. Fears of a new world conflagration, exaggerating the rise in demand for raw materials and equipment needed for the war effort of the United Nations, led to excessive spending in the industrialized countries; the inflow of an unprecedented amount of foreign exchange, reflecting the increase in the volume as well as in the price of raw material exports, produced similar excesses in many underdeveloped countries. When the crisis passed, some industrialized countries experienced a slight recession, but in most of them the upward movement was soon resumed.

By that time, however, recovery from the war had everywhere proceeded far enough to raise production above the prewar level, and to permit the restoration of economic flexibility in both domestic and international transactions. These changes made monetary policies more practical, both politically and economically. In 1951-52, therefore, all major industrial countries used monetary policies to reestablish or maintain financial equilibrium. Belgium, Italy, and Germany had already done so in earlier years; now they were joined by the Netherlands, the United Kingdom, and France. In no major country did wholesale prices rise significantly between 1952 and 1954.

Stabilization was not purchased at the price of economic stagnation. On the contrary, world production and world trade expanded at record rates. The physical volume of world exports rose in these years by 13 per cent, dramatically refuting the idea of a continuous decline in the importance of international commodity movements. The rise was even more rapid in the case of the European countries: the volume of exports of Western European countries (including the United Kingdom) rose between 1952 and 1954 by 21 per cent. The gold and dollar holdings of these countries increased between the end of 1951 and the end of the first half of 1955 by 55 per cent. And industrial production in Western Europe rose in that period by 24 per cent -- more than twice as fast as in the United States. In some countries, such as Germany, production has doubled since prewar days; in recent years, the countries with the most rapid advance have been by and large those with the best record of financial stability.

Such rapid progress, however, was bound sooner or later to build up renewed pressures. In contrast to the early postwar years,

but in line with post-Korean experiences, the Governments of most European nations recently threatened by this kind of "prosperity inflation" promptly applied again anti-inflationary monetary policies. Since the beginning of this calendar year, eight European countries have increased their discount rates, and some of them also have used other forms of monetary action.

In Germany, the central bank, in addition to raising the discount rate, increased the reserve requirements for commercial banks and, for the first time in postwar German monetary history, used open market operations in Treasury bills to tighten the money market.

In the Scandinavian countries, where the danger of inflationary developments was more urgent, the authorities used anti-inflationary fiscal as well as monetary policies. Denmark imposed a national sales tax, raised its excise taxes, and reduced housing subsidies; moreover, the National Bank raised the discount rate, reduced its support price for Government bonds, and urged the commercial banks to be more restrictive in their lending policies. Norway imposed taxes on investment; its monetary measures included a rise in the discount rate, the establishment of reserve requirements for commercial banks and of credit ceilings for mortgage credit associations, and an increase in the interest rates of Government bonds. Sweden introduced a tax on business construction and increased the rates of corporation taxes; in the field of monetary policy, it raised the discount rate, stimulated savings by offering Government-financed premiums for long-term savings deposits, increased interest rates of bonds issued by municipalities and public utilities, and induced the commercial banks to restrict their

lending under the threat of introducing compulsory reserve requirements.

The United Kingdom relied exclusively on weapons of credit and monetary policy, and so far has not adopted anti-inflationary tax measures. Early this year, the Bank of England raised its discount rate in two steps from 3 to 4-1/2 per cent. This action led to a general rise in the interest rate level and on the whole banks could expand their loans only if they sold their investments at a loss. The interest rates on Government loans to the local authorities, which provide the bulk of housing and other public work finance, were repeatedly increased. Instalment credit was curbed. Finally, in July, the Bank of England used also the weapon of "moral suasion" to induce the commercial banks to agree to a reduction by 10 per cent in the total amount of their loans; "moral suasion" can be effective under the British system of branch banking since lending policies are determined by a handful of large banks which maintain the closest ties with the monetary authorities.

This, then, is a short general review of credit and monetary policy both here and abroad. It is too early to judge the effects of the policy actions undertaken in recent months. On the whole, however, the record of the past three years gives evidence that flexible credit and monetary policy has contributed to stable economic growth. There have been many other factors contributing to the generally high level of production and employment, and to the stability of price levels. However, the role played by the banking system should not be overlooked. For this reason, a credit and monetary policy that enables the banking system to fulfill its economic functions and thus helps to maintain economic equilibrium, is of vital interest to us all.