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Cardinal O'Hara Lecture Remarks

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## The instruments of monetary policy in the United States

The basic function of the Federal Reserve System is to make possible a flow of credit and money that will foster orderly economic growth and a stable dollar. In performing this function the Federal Reserve depends chiefly on its ability to increase or decrease the availability, cost, and volume of bank reserves, which constitute the legally required basis of bank deposits. Changes in the reserve position of the commercial banks affect directly the flow of bank credit and money, which in turn are reflected in changes in the availability of credit and in interest rates throughout the entire financial system.

The three principal methods of regulating bank reserves are discounts for member banks, purchases and sales of government securities in the open market, and changes in reserve requirements. Discount policy and open market operations are more flexible and, hence, more adaptable to day-to-day changes in credit and monetary conditions than changes in reserve requirements. The principal method by which the Federal Reserve System takes the initiative in influencing the flow of credit and money is through open market operations. In periods when restraint is desirable and reserve availability is restricted, banks may feel obliged to borrow from the Federal Reserve Banks at the prevailing discount rate in order to meet part of their reserve needs. In periods of credit ease, purchases by the Federal Reserve of securities have the effect of adding to bank reserves, and thereby enabling banks to reduce their indebtedness with the Federal Reserve Banks.

Federal Reserve policy during the recession

In response to the course of economic recession and revival in 1958, the Federal Reserve System employed all the principal instruments of monetary policy--open market operations, discount rate adjustments, and changes in member bank reserve requirements. The policy of credit ease adopted in the fall of 1957 was continued and extended by a number of actions in the first half of 1958.

Open market operations early in the year absorbed a smaller portion than usual of the reserves released by the seasonal return flow of currency and decline in demand deposits. Further easing of member bank reserve positions in the spring and early summer was brought about by Federal Reserve open market purchases beginning in March and accelerating in May and June.

Complementary action to ease member bank reserve positions was taken in late February, when the Federal Reserve reduced reserve requirements. This reduction freed about $500 million in reserves, and was followed by further reductions of similar magnitude in March and April. Meanwhile the Federal Reserve lowered the cost of member bank borrowing by a three-step reduction in discount rates in January, March, and April, bringing the rate at all Reserve Banks to 1-3/4 per cent.

The effect of these Federal Reserve actions was that, in spite of the large increase in bank deposits and considerable loss of reserves through gold outflow, member bank excess reserves grew steadily while member banks reduced their borrowings at the Reserve Banks. From March through July the margin of excess reserves over borrowings averaged about $500 million.

When it became apparent shortly after midyear that the recession's low point had been passed and that a vigorous recovery was under way, the Federal Reserve began to temper the availability of reserve funds. Seasonal demands for credit were allowed to tighten member bank reserve positions beginning in August.

In these circumstances, discount rates were increased in August-September from 1-3/4 to 2 per cent. A further increase to 2-1/2 per cent followed in late October and early November. Member bank reserve positions continued to tighten moderately.

In the final three months of the year, Federal Reserve open market purchases aided banks in accommodating seasonal demand for credit and currency. In addition, member banks increased their borrowings at Reserve Banks. Such borrowings averaged about $500 million in December, or $50 million higher than excess reserves. The reserve status of member banks changed little in January 1959, as Federal Reserve open market sales about offset the usual seasonal influences that tend to increase the availability of reserve funds.

In early March 1959 discount rates were raised in a number of Federal Reserve Banks from 2-1/2 to 3 per cent to bring discount rates into closer alignment with market rates.

The Federal Reserve made three changes during 1958 in the margin required for the purchase of stock market securities. In January, in response to reduced use of stock market credit following the decline in stock prices in the early fall of 1957, the required margin was reduced from 70 to 50 per cent. Following a rapid rise in the amount of stock market credit in

spring and early summer, which was accompanied by substantial increases in stock prices and the volume of trading, margin requirements were restored to 70 per cent in early August. The volume of credit continued to rise, however, and in mid-October the margin requirement was further increased to 90 per cent.

The Board is considering possible amendments to its margin regulations--Regulation T that applies to brokers and dealers and Regulation U that applies to banks. On March 13 the Board filed those proposed amendments with the Federal Register for publication and comments. The proposed amendments would further restrict withdrawals and substitutions of cash and collateral under both regulations in so-called "restricted" accounts, that is, accounts in which more credit is outstanding on securities than would be permitted in a new purchase of those securities under current margin requirements. The proposed amendments would also make a number of other changes in Regulation U, the regulation applicable to banks, in order to increase the effectiveness of that regulation. Any comments on the proposed amendments are to be submitted by April 6, 1959.

<u>The outflow of gold and the drop in U. S. exports</u>

In recent months there has been a good deal of comment in the domestic and in the international press about the significance of the large outflow of gold and the sharp fall in U. S. exports in 1958. The more sensational commentators have purported to see in the first of these developments a flight from the dollar and in the second proof of the loss of competitiveness of U. S. products on world markets. In fact, neither of these allegations can be seriously maintained in the light of the evidence.

During 1958, when there was an outflow of $2.3 billion in gold, foreigners had sufficient confidence in the dollar to increase their liquid dollar holdings in this country by $1 billion net. Instead of running away from the dollar by converting their existing balances into gold, foreign countries simply took a good part of the increases in their official foreign exchange reserves in the form of gold--a customary practice for many European countries who like to keep most of their reserves in gold. The real reasons for the outflow of gold must then be sought in the changes in our international payments positions which led us to pay out substantially more dollars than we took in.

First, during the 1957-58 recession U. S. exports fell by almost 20 per cent while imports were sustained, in part, by high levels of con-

sumer expenditures in the U. S. The reasons for the fall in exports will be discussed shortly, but the result of this development was to keep foreign earnings of dollars at high levels while reducing our earnings from abroad.

Second, U. S. capital exports in the form of U. S. purchases of foreign securities, U. S. private loans abroad and direct investment by American firms in foreign countries remained at high levels during the recession. To a great extent growing U. S. foreign investment abroad reflects the success of our postwar policy of rebuilding confidence in the free world trade and payments mechanism. U. S. capital is attracted by high rates of return abroad, including interest rates generally higher than at home. The outflow of U. S. private capital in 1958 was actually higher than our loss of gold so that in one sense it might be said that as a nation we exchanged gold for ownership of profitable investments abroad.

Third, U. S. Government loans and grants to foreign countries remained at high levels during 1958, thus contributing to our net payments abroad. This foreign aid is, of course, an important aspect of our policy of building a free international economy which is strong both economically and militarily. In addition, a large part of our aid program is directly connected with the export of U. S. products abroad; indeed, in the case of our surplus agricultural products sold for foreign currencies the aid is in the form of the exports of such products.

What of the contention that U. S. exports are no longer competitive? An examination of the facts indicates that the decline in demand was

in large part related to the falling off of investment activity especially a decline in the rate of inventory accumulation in Europe even before our own recession and to declining incomes of raw material producing countries. Some two-thirds of the decline in our exports was in the field of raw materials and semimanufactures, which are highly sensitive to cyclical forces. During the boom period from 1955 to 1957 foreign countries had built up large inventories of raw cotton, coal, and metals. Furthermore, our exports, particularly of oil, had expanded abnormally as a result of the Suez crisis, and of over importing by countries such as France, India, and Japan. While our exports of manufactured products fell during 1958 this too was in part related to reduced purchasing power in some of our markets. The growth of U. S. exports of manufactured products since 1955 has not been out of line with that of other countries except perhaps Germany, Italy, and Japan, which started from very low levels and are only now regaining their prewar positions. In the past several years industrial prices have not risen significantly more here than in other major countries.

It is nevertheless essential to recognize that changing competitive relationships over time for individual products are bound to make us relatively more efficient in some kinds of production and less so in others.

While it can be said with some assurance that there is little evidence that we are at present pricing ourselves out of world markets in any general sense it is necessary to recognize that the physical and financial recovery of Western European countries and Japan has made them more competitive. Of course, excessive inflation at home would have serious consequences

both for our external as well as our internal stability. In a world of convertible currencies we can no longer count on other countries inflating more than we do and thus shielding our balance of payments from the consequences of our failure to adopt responsible monetary and fiscal policies.

Finally, it should be noted that our competitive position can only be fully tested where restrictions do not prohibit competition. There is little excuse any longer for the maintenance in any country of discrimination against dollar goods. By the same token a freer system of world trade and payments can only be achieved if the U. S., the largest supplier of international means of payments in the world, resists protectionist pressures and continues to demonstrate its adherence to liberal trade policies.