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INITIATIVE AND INNOVATION IN CENTRAL BANKING:

The Orchestration of Monetary, Fiscal and
Debt Management Policies

Remarks by

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INITIATIVE AND INNOVATION IN CENTRAL BANKING:

The Orchestration of Monetary, Fiscal and Debt Management Policies

The objectives and content of monetary policy in 1966 have been widely discussed and--quite properly--are now being consigned to history. Moreover, with the publication earlier this week of the Federal Reserve Board's Annual Report covering 1966, the official account for last year is also in the public domain. Thus, the present is a good time--and this meeting of economists and business administrators is a good place--to review the record of monetary management and to draw from the experience a number of lessons which may be instructive in the future.

As I look back on 1966, I am struck (along with everyone else) by the enormous pressures generated in an economy already in the neighborhood of full employment yet required to cope with a large and sharply rising volume of military expenditures. I am also struck by the high volume of funds which had to be mobilized to finance a vigorously expanding private economy and an extraordinary level of spending in the public sector--by both the Federal and State and local governments. Under these circumstances, the fact that credit availability was severely limited and interest rates rose to the highest levels in 40-odd years is not at all surprising.

In my personal judgment, the really significant point is that general stabilization policies worked as well as they did in 1966--given the numerous constraints under which they had to operate. The disproportionately heavy burden carried by monetary policy is now widely recognized.

While fiscal policy was also helpful in moderating the pace of expansion, its contribution was less direct and its timing delayed. Moreover, the increased need for funds by the Federal Government gave rise to debt management problems that became additional sources of stress in the financial markets in 1966.

From an examination of the record of economic developments, monetary policy and stabilization efforts in 1966, the following picture emerges:

- The vigor of economic expansion, beginning in the closing months of 1965, clearly called for a policy of vigorous restraint.
- Monetary policy responded relatively early. After an initial period of market adjustment to the overt shift to restraint, bank reserves were kept under progressively greater pressure through June of last year. As the impact of restraint permeated the economy, it became increasingly necessary to employ monetary instruments in different combinations and to redistribute the effects of a restrictive credit policy. As inflationary pressures moderated in the fall, an overt shift to a policy of ease was made promptly.
- Counter-inflationary fiscal policy was both late and mixed. While exerting some restraint on the economy as a whole during the year, the techniques of raising revenue (particularly the acceleration of tax collections) also generated substantial liquidity pressures upon taxpaying corporations and, in turn, on the banking system to which they turned heavily for financing. Moreover, the sizable increase in the cash deficit compelled the Government to become one of the strongest competitors in the capital market and a major force in the sharp climb in interest rates.

- Debt management policy, while not unduly constraining the conduct of monetary policy, also had a profound effect on the pattern of financial flows and the cost of borrowing.

Given the above configuration of stabilization policies (and the varying degree of success achieved in their use), it seems evident that a far better orchestration of these policies is required. Undoubtedly, further improvements are needed to enhance the efficiency of monetary policy. However, the most pressing task is to increase the flexibility of fiscal policy--especially through permitting more timely changes in corporate and personal income tax rates. Once we have achieved a better balance between monetary and fiscal policy, the overall objectives of stabilization can be further enhanced by removing the constraints under which debt management operates. This includes not only removal of the interest rate ceiling on Treasury bonds, but also improved budgetary measures which would, among other things, make it less necessary to sell participation certificates (PC's).

I realize, of course, that no time is ideal to press for a better integration of stabilization policies. Yet, with memories of the costly consequences of a failure to integrate such policies so fresh in our minds--and in view of the obvious need for a better policy mix in the future--we ought not to put off indefinitely the careful consideration of means to mesh fiscal and debt management policies more closely with monetary policy.

Because of the need to improve the mix of stabilization policies, I personally favor the adoption of some version of the surtax on corporate and personal income such as that which the Administration has recommended to Congress.

Mainsprings of Excess Demand

Before appraising the attempts to orchestrate stabilization policies in 1966, it would be helpful to pause briefly to highlight the principal developments which challenged--and almost ended--the 5-year record of stable economic growth. In 1966, gross national product rose by \$58 billion to a total of \$740 billion, measured at current prices. This was a gain of 8.6 per cent over the previous year. However, the rise in real output was substantially less (5.4 per cent) as the GNP price deflator climbed by roughly 3.0 per cent. In fact, the increase in real output and prices exceeded that which had been implied by most projections (both official and private).

The key components of this vigorous expansion in demand have been thoroughly analyzed and can be summarized here:

- The quickening of defense spending induced by the military effort in Vietnam must necessarily be assigned first place. Defense outlays, which rose by over \$2 billion at an annual rate in the last half of 1965, climbed sharply in 1966. The rise was particularly sharp during the third quarter when an increase of nearly \$5 billion was recorded. For the year as a whole, defense expenditures advanced by \$10 billion. This was considerably in excess of the level anticipated at the beginning of the year when the basic strategy of stabilization policy was adopted.
- The second most critical expansive force was business fixed investment. Last year, such outlays totaled \$79.3 billion, a rise of \$9.6 billion or nearly 14 per cent. At this level, such spending represented 10.7 per cent of GNP, the highest annual ratio of the postwar period.

- Business inventories (partly reflecting the defense buildup and the high level of spending for fixed capital) also rose dramatically. Over the year, nonfarm inventories expanded by \$4 billion; but in the fourth quarter of 1966, the accumulation was at an annual rate of approximately \$18 billion--roughly double that in the same period a year earlier.

Other sectors also added substantially to the expansion of demand:

- Expenditures by State and local governments increased by \$7 billion. This was the largest rise on record, and the impact on resources (especially on manpower) was particularly strong.
- Consumers, with a considerable advance in disposable personal income over the year, increased their spending in absolute terms by nearly 8 per cent in 1966. However, since prices rose sharply, their real income expanded by only 3 per cent and their physical volume of spending by only 5 per cent.

However, while most sectors were adding to the strong expansion of the economy, this was not true of housing. Last year, outlays on residential structures amounted to \$25.8 billion, a decrease of \$2 billion, or 7 per cent, from 1965. Actually the decline in residential construction was even more severe than is implied by the expenditure figures, because these reflect rising unit prices and a continuing trend toward more expensive single-family units. A more accurate picture of the experience of housing is given by the figures on housing starts. For the year as a whole, nonfarm starts totaled 1.2 million units (the lowest since 1957) compared with 1.5 million in 1965. Moreover, the decline was particularly sharp after April, and by the fourth quarter starts were

less than 1 million units at a seasonally adjusted annual rate.

The reasons for this adverse experience of the housing sector are widely known: Among them the outstanding factor was the sharp reduction in the availability of funds as principal mortgage lenders found it increasingly difficult to compete against the securities market and commercial banks in an environment of rapidly rising interest rates.

General Strategy of Economic Stabilization

The requirements of a proper public policy to counter inflationary pressures are well understood, and need not be discussed here. Instead, it is sufficient to recall that the basic aim should be to moderate forces, inherent in the private economy, which may tend either to expand aggregate demand ahead of the growth of real resources or to fall short of reasonably full utilization of manpower and physical capacity.

In the conduct of a well designed stabilization policy, the principal policy instruments might be employed as follows:

Counter-Cyclical Policy Actions

<u>Type of Policy Instrument</u>	<u>Inflation</u>	<u>Recession</u>
<u>Monetary Policy</u>	Restraint	Ease
Open Market Operations	Sell Securities	Buy Securities
Discount Rate	Raise	Reduce
Reserve Requirements	Raise	Reduce
Selective Measures	Strengthen	Relax
<u>Fiscal Policy</u>		
Expenditures	Restrain	Expand
Revenue	Rise	Decline
Automatic Response	Rise	Decline
Tax Rates	Increase	Decrease
Budget	Surplus	Deficit
<u>Debt Management</u>		
Maturity of Debt	Lengthen	Shorten
Type of Securities:		
Short-term	Restrict Sales	Expand Sales
Long-term	Expand Sales	Restrict Sales

Of course, it is recognized that an ideal mix of policy actions can seldom, if ever, be achieved. However, the above scheme does provide a convenient framework within which to appraise the actual performance of stabilization policies in 1966.

Monetary Policy in 1966

Even a casual reading of the record of Federal Reserve policy actions during 1965 and 1966 clearly shows that, for the most part, monetary policy did respond in the fight against inflation in essentially the way suggested by an informal stabilization policy. From mid-summer of 1965, the Federal Open Market Committee (FOMC) became increasingly concerned about the inflationary implications of increased military spending superimposed on an expanding private economy. Partly in response to expectations, interest rates rose noticeably in September 1965, and the tone of the money market became quite firm. Although the FOMC took no overt step toward greater credit restraint during the following few months, it did attempt to maintain the firmer tone which had been achieved.

However, the explicit shift to a policy of restraint was taken in early December with an increase in the discount rate to 4-1/2 per cent and in the maximum rate which member banks could pay on time deposits to 5-1/2 per cent. From then through all of 1966, the Federal Reserve made extensive use of a variety of monetary policy instruments, including open market operation, changes in reserve requirements, administration of the discount window and ceilings on time deposit rates.

Open Market Operations

For the first two months following the rate changes of early December 1965, the principal aim of open market operations was to facilitate adjustments in credit markets. In the process, a sizable amount of nonborrowed reserves was supplied to member banks. Subsequently, once this adjustment had occurred, open market operations exerted gradual--though substantial--pressure on the availability of reserves. For example, from February through June, nonborrowed reserves rose at an annual rate of only 1.7 per cent; in the preceding seven months the annual rate of growth was 4 per cent.

On the other hand, the acceleration of corporate tax payments (a key component of new fiscal policy measures) generated considerable money market pressures around the tax periods of March, April, and June. To help moderate this impact, the Federal Reserve supplied a significant amount of new reserves through open market operations.

Nevertheless, the main thrust of System operations in Government securities during the February-June period was to restrain the growth of bank reserves in the face of a large and continued demand for credit. To a considerable extent these demands were dominated by a wave of corporate bond flotations and sizable offerings of participation certificates (PC's) by the Federal Government. The result was a general rise in interest rates, including the prime lending rate at commercial banks.

In this environment, individual savers were attracted increasingly to high-yielding market securities and away from depository institutions--away from commercial banks as well as from mutual savings banks and savings and loan associations (S&L's). While all types of institutions struggled against the pull of the market, commercial banks were relatively more successful than were S&L's and mutual savings banks in holding on to their sources. Through offering rates up to the 5-1/2 per cent maximum permitted on negotiable certificates of deposit (CD's), the banks attracted a substantial volume of funds from corporations and other large investors. They also devised a variety of consumer-type instruments on which they could pay rates in excess of the 4 per cent fixed on regular savings accounts. The net result was a further strengthening of the commercial banks' position compared with that of other depository institutions. With the intensification of competition for funds as the summer progressed, open market operations--while clearly remaining an active tool of credit policy--moved from center stage as the System reached for other instruments more finely tuned to cope with the new complex of problems.

Changes in Reserve Requirements

First in July and again in September of 1966, the Federal Reserve Board increased reserve requirements against time deposits

at member banks with total time accounts in excess of \$5 million. Each change amounted to one percentage point, and together they raised the requirement from 4 per cent at the end of June to 6 per cent at the end of September.

In both cases, the objective was to temper bank issuance of CD's. Another aim was to moderate the extension of bank credit to business borrowers. While total bank credit expanded at an annual rate of about 9 per cent during the first eight months of 1966, business loans rose at an annual rate of 20 per cent in the same period.

Although these increases in reserve requirements only made it slightly more expensive for banks to compete for large denomination CD's, they did express clearly the Board's view that more moderation in bank lending was desirable.

Discount Rate

On July 15, 1966 the Federal Reserve Board declined to approve proposals by four Reserve Banks to raise their discount rates to 5 per cent. (Other proposals to increase rates up to 5-1/2 per cent were also declined between July 19 and September 2).

However, from late last spring until well into the fall, a further increase in the discount rate was a matter of much debate-- within the Federal Reserve System as well as in the financial community generally. In fact, the decision not to raise the discount rate again after the move in December 1965--despite the vigorous exercise of other techniques of monetary restraint--has generated a considerable amount of adverse comment. With subsequent publication of the full range of considerations which the Board took into account in reaching its decision, our general approach to the discount rate last year is now widely appreciated.

While a great debate was sparked by the increase in the discount rate when the policy of restraint was publicly signaled in late 1965, it is clear in retrospect that the move was entirely proper. Moreover, in my personal judgment, there were a few other times before mid-summer last year when another increase in the discount rate would have been proper. Aside from the aid it would have given in the restraint of domestic demand the change would have also provided assistance to our balance of payments.

On the other hand, as all types of interest rates moved up rapidly to levels not seen in 40-odd years, the question of further escalation of the rate structure became particularly critical.

Restoration of the historical relationship between the discount rate and other short-term rates was no longer a matter of great urgency. While it was recognized that expectations about prospective discount rate changes increasingly had become a factor in the actual behavior of the market, the benefits to be derived from validating such expectations were outweighed by the costs that a validating increase would have entailed for other objectives of monetary policy.

Among the latter, at the time the rate change was proposed in mid-July, was the stabilization of the foreign exchange market. On the day prior to the Board's decision, the Bank of England had raised its discount rate from 6 to 7 per cent as part of a concerted campaign to strengthen the position of the pound sterling. Some of us thought that an almost simultaneous increase in the discount rate at the Reserve Banks would have seriously undercut the support efforts for sterling--and indirectly may have had an adverse impact on the dollar itself.

My agreement with the course we followed last year with respect to the discount rate does not mean that I believe the discount rate has ceased to be a useful instrument of monetary policy. Quite the contrary. As was subsequently demonstrated by the reduction in the discount rate last month, such changes can communicate reasonably well Federal Reserve policy objectives to the general public. I am confident that the discount rate will remain a viable instrument in our kit of monetary tools.

Selective Measures

While relying primarily on general tools of credit control, the Federal Reserve found it necessary, however, to tailor its approach to deal with the peculiar complex of pressures which developed in the summer of 1966. The first effort in this direction was aimed at moderating the excessive competition for funds sparked by commercial banks' use of a wide range of instruments such as "savings bonds" and "savings certificates." The key feature of these devices was the ability of the banks to offer a rate of interest greater than the 4 per cent which they were permitted to pay on regular savings accounts. To some extent, the increases in reserve requirements against time deposits were aimed at these practices. The Board also restricted the use of consumer-type CD's offering multiple maturities.

However, because of the Board's limited authority, little could be done effectively to reach the source of the difficulty. For this reason, we requested authority (which Congress granted in September) to set interest rate ceilings on time deposits on the basis of a variety of criteria--including size. With this authority in hand, we fixed a 5 per cent ceiling on CD's under \$100,000 while leaving the limit unchanged at 5-1/2 per cent for CD's above this amount which were issued primarily by large

money market banks. Other supervisory agencies fixed maximum rates for the institutions under their jurisdiction. In taking these actions, we fully appreciated that they were by no means ideal. Yet, they were clearly necessitated as a temporary means of moderating the excessive competition for savings. These steps were clearly helpful to S&L's as well as to banks.

Another move, taken earlier in the summer, was also designed to assist S&L's and mutual savings banks faced with unusually large withdrawals of funds. On July 1, the Federal Reserve Board quietly authorized the Federal Reserve Banks to provide emergency lending accommodation to nonmember depository-type institutions in the event of extraordinary liquidity pressures. Fortunately, the need did not arise.

Undoubtedly, the action that has attracted most comment was the System's letter of September 1, 1966, to member banks. This communication was designed explicitly to ease capital market pressures which developed in late August and continued into September. In this letter, the System's determination to allow a continued orderly (though moderate) growth in bank credit was made unmistakable.

At the same time, the need to moderate the expansion of business loans was stressed, and banks were cautioned concerning the market pressures created by the heavy liquidation of municipal securities. Finally, a modified approach to the administration of the discount window was outlined. Banks were told that, while their Reserve Banks would continue to assist them as usual in meeting seasonal or emergency needs for funds, they would also keep in mind the extent of the borrowing bank's efforts to moderate the growth of business loans, in adapting to any shrinkages in their source of funds. I do not wish to claim that the approach outlined in the September 1 letter was the key factor underlying the easing of market pressures in September. Other factors (particularly the re-appearance of the prospect of additional fiscal restraint) may have played a far more important role. Nevertheless, this reassurance that the System was prepared to come to the market's assistance was undoubtedly helpful. With the subsequent shift to a policy of ease which got underway in the fall, the September 1 letter was rescinded in late December.

The above steps demonstrated clearly the willingness of the Federal Reserve to innovate in monetary management. Again, however, a decision not to act in accordance with market expectations can also be helpful in achieving overall policy objectives. It will

be recalled that the maximum rate of interest payable on time deposits was raised to 5-1/2 per cent in December 1965. The action was motivated partly by a desire to ease the pressure of advancing market yields on the large volume of CD's held by commercial banks.

During the summer, market rates again began to press against the 5-1/2 per cent ceiling, and the prospect of attrition in bank holdings of CD's reappeared. This time, however, the rate ceiling was not raised. Instead, it seemed appropriate to allow some attrition to develop and thus re-enforce the effort to moderate the expansion of commercial banks' business loans. This fact has convinced some observers that the approach last summer was inconsistent with that followed in December 1965. Actually no such paradox exists: the need to moderate credit growth was much greater in 1966 than was the case at the outset of the restraint policy. By raising the ceiling earlier--and not raising it last summer--we were pointing our efforts at the same target, that is, a rate of growth of bank credit more in line with the availability of the country's real resources.

The Lessening of Credit Restraint

After late summer, credit demands became less intense. Perhaps this was partly a reflection of the high level of borrowing early in the year (some of which was undoubtedly anticipatory) as well as the change in the pattern of business borrowing to settle tax liabilities. But given the degree of monetary restraint exerted after December 1965, undoubtedly a significant effect was registered on the demand for credit. While the overall demand for funds remained strong through the closing months of the year, there was no return to the frantic pace of business loan growth. The atmosphere in the securities markets became much quieter than it was over the summer. Although the volume of market flotations remained large, and yields continued exceptionally high, the capital markets continued to function rather well.

In the face of these developments, monetary policy during much of October was directed toward lessening somewhat the restraint on banks. Finally, in the third week of November, the FOMC adopted an overt policy of ease, and this was reinforced in December. In further pursuit of this policy, reserve requirements against certain

types of time deposits were reduced toward the end of February, and the discount rate was cut to 4 per cent earlier this month.

The response of the financial system to these moves has been dramatic. Sizable free reserves have reappeared at member banks, and interest rates have declined sharply from the peaks reached in 1966. Banks and other depository institutions have regained their ability to compete successfully for savings, and inflows are occurring in near-record volume. Even the large money market banks have more than recovered the \$3 billion of CD's which they lost between last August and December as market yields rose above the maximum rates they could pay on time deposits. Bank credit and the money supply have also expanded substantially--in keeping with the requirements of a monetary policy designed to see the economy through a period of inventory adjustment and an overall pace of slower growth in real output.

The Performance of Fiscal Policy

In view of the widespread debate over the nature and content of fiscal policy actions in 1966, one could easily gain the impression that fiscal actions made little contribution to the stabilization efforts last year. Such an impression would be entirely incorrect. Estimates by some Administration officials have placed the fiscal contribution to restraint in the neighborhood of \$10 billion.

It will be recalled that modest tax increases became effective in late winter and spring of 1966. These consisted principally of a restoration of previous reductions in excise taxes on automobiles and telephone service, and the acceleration of personal and corporate income tax payments. Then, about the first week in September, temporary suspension of the 7 per cent investment tax credit was recommended, and the measure was adopted in October.

This configuration and timing of fiscal action should be kept in mind, because to a considerable extent they conditioned the configuration and timing of monetary management in 1966. In fact, throughout the year, most of us in the Federal Reserve System were fully conscious of the critical importance of fiscal policy to the success of our own efforts. Regarding my personal position on the question, I said in mid-July that I felt a general tax increase would have been desirable early in 1966. I went on to say that, in the absence of such a move--and in the face of the continued rapid expansion of outlays on plant and equipment and of bank loans to business to help finance these outlays--I thought it would be helpful to suspend temporarily the investment tax credit. Therefore, I was pleased when this step was taken.

The Federal Budget

As measured in the national income accounts, the Federal budget was a lesser source of restraint on aggregate demand in calendar 1966 than it was in 1965--despite the fact that for the year as a whole a surplus of \$0.3 billion was recorded. In the previous year, the surplus had amounted to \$1.6 billion. Within 1966, the budget registered a moderate surplus during the first six months. However, by the second quarter, a small deficit had appeared, and this became substantial in the final three months of the year. For 1966 as a whole, the essentially balanced position resulted primarily from higher tax receipts as incomes rose sharply. But the fiscal policy actions mentioned above also helped.

The Federal Government's cash budget showed a deficit of \$5.7 billion in calendar 1966, the largest since 1961. Total cash payments rose by \$23 billion, over half of which was represented by higher defense expenditures. Tax receipts expanded by nearly \$22 billion to a record level last year. Again, this increase can be traced largely to the rapid growth of the economy. However, about \$5.5 billion of the increase resulted from higher social security and medicare taxes. In addition, roughly \$6 billion (or over one-quarter of the rise) came through an acceleration in tax payments. As observed above, this latter

fiscal measure placed considerable pressure on the banks as many corporations had to borrow amounts greatly in excess of what they would have required in order to meet the usual tax payments.

The Performance of Debt Management

The management of the Federal debt can make a substantial contribution to stabilization policy. To be sure, considerations of good debt housekeeping and market feasibility constrain what can be done in this area. Nevertheless, during a period of emerging inflation pressures, debt decisions could be tilted in favor of lengthening the maturity of the debt insofar as practicable, and the reverse should be the objective as periods of recession develop.

As we know, the Government's ability to manage its debt remains severely constrained by the 4-1/4 per cent interest ceiling on Treasury bonds. During 1966, this ceiling made it impossible for the Treasury to sell any direct debt maturing over 5 years. Moreover, the Treasury lost a sizable proportion of the longer average maturity of the debt which it had achieved during the preceding 6 years.

The Treasury was also constrained by the legal limit on the size of the debt. Toward the close of the year, the amount of the debt outstanding came exceptionally close to the statutory ceiling, and on several occasions the Treasury's operating balance fell to exceptionally low levels. In early December, the Treasury borrowed \$169 million directly from the Federal Reserve over one weekend.

The Federal Government was a net seller of \$10.0 billion of securities in 1966, more than double the net amount sold in the previous year. Included were \$3.4 billion of marketable direct debt--all of less than 5-year maturities. On the other hand, sales of direct agency issues amounted to a record \$5.1 billion. Moreover, an exceptionally large volume of PC's (\$1.5 billion) was also placed on the market.

The unprecedented sales of agency issues and PC's were significant factors underlying the rise in money market rates and the congestion in the financial markets. In an effort to moderate these pressures, after midyear, Treasury investment accounts began to absorb large amounts of agency securities. Finally, after September, the Government made no further sales of new PC's. In the face of this reduction in sales of agency securities and PC's, the Treasury drew down its cash balance in the last half of the year and also expanded its sales of direct obligations.

The Need for a Better Policy Mix

The foregoing discussion clearly demonstrates that the record of stabilization efforts last year was far from ideal. Without attempting to pass out "grades" (and perhaps at the risk of appearing biased by my institutional connection), it seems to me that monetary policy did perform somewhat better than either fiscal or debt management in 1966. Again this comparison certainly is not intended to be invidious. Rather, the point is that, while all three types of policies had to operate under great handicaps last

year, the constraints on fiscal measures and debt operations were far more serious.

As I look ahead--and without attempting in anyway to forecast the performance of the economy or the course of monetary and credit conditions over the rest of this year--I am personally convinced that we will need a better balance among our stabilization instruments. Exactly how to achieve this is by no means obvious. But it is self-evident, however, that we should rely on fiscal policy as a source of a greater share of whatever overall restraint on aggregate demand we may require in the future. Also, with a more effective fiscal policy, it would be less necessary for the Government to rely so heavily on market borrowing, and this would certainly ease the problems of debt management.

These considerations have led me to conclude that Congress should write into law some variety of surtax on corporate and personal income such as that which the Administration has recommended. In taking this view, I am not necessarily suggesting that the rate (6 per cent) or the effective date (July 1) originally proposed is exactly right. Both of these features can more properly be determined against the background of economic developments at the time the measure is actually considered. In my opinion, the important thing is that fiscal action along this line be taken before the current session of Congress adjourns.