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NEW HORIZONS IN MONETARY AND FISCAL POLICY

Remarks by

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By
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Long before we reached the present stage of the current inflation in the United States, a vigorous program of fiscal restraint was clearly required. Such a program is a desperate need today. And while I (along with virtually all other observers) have learned over the last few years not to be particularly optimistic about Congressional response to the need for fiscal restraint, there is still reason to expect that some combination of higher income taxes and reduced Federal expenditures will be adopted to apply to fiscal year 1969. The combination with the strongest Congressional backing to date involves a 10 per cent income surtax, a \$6 billion reduction in expenditures and cutbacks in past and future appropriations.

The adoption of this set of fiscal measures would enhance -- not lessen -- the need for flexibility in monetary management. On numerous occasions, I (and many others in the Federal Reserve System) have advocated more assistance from fiscal policy partly as a means of reducing the burden of restraint carried almost entirely by monetary policy. Once more fiscal restraint is actually in force, it will be vital to mesh the two sources of restraint to ensure that the pace of the economy is moderated in an orderly way in the months ahead -- particularly in light of the unfolding effects of the monetary actions already taken.

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In my own view, to date we have not achieved enough restraint on aggregate demand to check inflation in the United States within a reasonable period of time. Thus, we need more total restraint. This goal can be achieved by either a somewhat firmer monetary policy, by a vigorously restrictive fiscal policy or by some combination of the two approaches. Personally, I would clearly prefer the third alternative, calling for more fiscal -- and less monetary -- restraint. However, just how much of a constraint would be imposed on such a choice by the pervasiveness of domestic inflationary pressures and the serious deficit in our balance of payments is obviously one of the most critical questions the monetary authorities will have to face once the proposed fiscal measures have been actually adopted. I shall return to this question later in these comments.

In the meantime, the central theme of these remarks can be summarized briefly:

- Since the shift to a policy of restraint last November, the Federal Reserve System has brought the rate of growth of member bank deposits to less than half that recorded last year. Moreover, restraint has been brought about much more rapidly (and to date much more smoothly) than was the case in 1966.
- The effects of monetary restraint (delayed and partly masked by a web of institutional relationships) are becoming increasingly evident. Flows to savings institutions have slowed substantially. The number of new housing starts, until a sharp jump in April, had been on a plateau for several months. As these effects permeate to other sectors, the degree of monetary restraint achieved so far would lead to some moderation in the pace of domestic economic activity in the closing months of 1968 and in the first half of 1969.

- Fiscal restraint of the magnitude now being considered in Congress, even taken alone, would also have a sizable impact on the economy in the first half of 1969. Previously approved -- but delayed -- Social Security taxes will also become effective early next year. Thus, if the surtax and expenditure reduction proposals are adopted in the near future, fiscal policy will -- finally -- become a significant means of checking inflation.
- On the other hand, the cumulative impact of the present degree of monetary restraint plus the restraint to be generated by the new fiscal measures may turn out to be more than the economy requires as the year 1969 progresses. Consequently, a high premium must be placed on the sensitivity and flexibility of monetary management in the months ahead.

Recent Trends in Monetary Policy

The principal actions taken by the Federal Reserve since a policy of restraint was adopted last November have been commented on rather widely. However, it may be helpful to summarize them here:

- The discount rate has been raised three times: from 4 to 4-1/2 per cent in mid-November; to 5 per cent in mid-March, and to 5-1/2 per cent effective April 19. The first increase was made in the context of adjustment following the devaluation of sterling, and the second move was part of a package of coordinated measures designed to cope with speculation against the official price of gold. The last increase represented a further step to bring about greater restraint to help counter domestic inflation and to contribute to improvement in our balance of payments.
- About \$550 million of bank reserves were absorbed in mid-January by an increase of 1/2 percentage point in reserve requirements on demand deposits above \$5 million at each member bank.
- Open market operations, on balance, have been used to absorb (rather than supply) reserves, so that the net growth in reserves since last November has come about

entirely through member banks borrowing from Federal Reserve Banks. At the same time, a considerable volume of Treasury financing has been accommodated.

- The maximum rates of interest payable on large-denomination time deposits were raised slightly effective April 19. This move was intended to moderate the rate of attrition in such deposits -- and not to ease credit conditions generally. Ceiling rates on savings and other time deposits were not changed.

I would like to stress that policy actions during the present period of monetary restraint have been undertaken in a deliberate and moderate manner. All the major policy instruments have been employed in a coordinated way, and excessive reliance has not been placed on any particular measure. Throughout, the basic aim has been to restrain the growth of bank credit and the money supply without creating excessive strains on the nation's financial fabric and without disrupting the basic functioning of the economy.

Impact of Monetary Restraint

The above policy actions have had a noticeable effect on money and credit flows. This is clear from the statistical measures summarized in Table 1. Several general conclusions can be drawn from these figures. It is evident that the impact of credit restraint in the current period has been registered on monetary flows much more rapidly than was the case two years ago. It will be recalled that the previous period of monetary restraint got underway early in December, 1965, while the current effort began in mid-November, 1967. Thus, the

Table 1. Annual Percentage Rates of Change
in Monetary Indicators for Selected
Periods

Series - Seasonally Adjusted	Year 1965	Dec. 65- Apr. 66 ^{1/}	Year 1966	Year 1967	Dec. 67- Mar. 68 ^{1/}	Dec. 67- Apr. 68 ^{1/}
Total Reserves	5.2	7.7	1.2	9.8	6.5	3.5
Nonborrowed Reserves	4.2	4.9	0.8	11.5	-0.4	-2.3
Total member bank deposits	9.1	7.6	3.7	11.6	5.5	3.5
Time deposits	16.0	10.4	8.8	15.8	6.7	5.6
Money supply	4.7	7.0	2.2	6.5	3.6	4.6

1/ Dates are inclusive

impact of restraint during the last five months can be compared with the experience in the same months two years ago. At the same time, however, one should remember that the really severe effects of restraint in 1966 were not registered until after mid-year.

In reviewing the current experience, one should note that the growth of bank reserves, deposits and the money supply has been reduced sharply -- with growth rates ranging from roughly one-third to one-half those recorded in 1967 as a whole. One should note particularly that the Federal Reserve has made no net contribution to bank reserves on its own initiative during the last five months. In fact, on balance, it has absorbed reserves, and all the net growth in reserves since November has come about by member banks borrowing from Federal Reserve

Banks. Total reserves have expanded at an annual rate of about 3.5 per cent, but nonborrowed reserves have actually declined at an annual rate of 2.3 per cent. This result has been achieved despite the fact that the System found it necessary to purchase over \$2 billion of Government securities to cushion the reserve impact on the domestic banking system of the substantial outflow of gold. In contrast, total reserves expanded at an annual rate of nearly 8 per cent in the first five months of credit restraint two years ago, and the System supplied nearly two-thirds of the net growth.

Since the end of last November, total member bank deposits have increased at an annual rate of 3.5 per cent; this is just over one-quarter the rate registered last year and less than one-half the rate of growth during the first five months of credit restraint in 1966. Treasury financing patterns have resulted in month-to-month fluctuations in the pace of expansion, but the trend has been distinctly downward. Between the end of November and the end of March, the money supply expanded at an annual rate of 3.6 per cent. This rate of growth was about half that recorded in both 1967 and in the first five months of restraint in 1966. However, the money supply took a sharp jump in April raising the growth since November to an annual rate of 4.8 per cent. This temporary bulge (which was concentrated around mid-month) reflected in large part both rapid growth of currency in circulation and large net transfers from U. S. Government to private demand deposits. Between mid-April and mid-May, currency in circulation grew at a much more moderate pace, but shifts from

Government to private checking accounts remained relatively large. So, while the growth of the money supply has declined from the high April rate, it has not receded to that registered from November through March.

The inflow of time deposits at commercial banks has slowed noticeably. During the five months ending in April, the annual rate of expansion was 5.6 per cent. This was about one-third that recorded for 1967 and just over one-half the rate of increase in the December-April months of 1965-66. Moreover, most of the increase in time deposits during the current period of credit restraint occurred before the end of March. In April alone, the annual rate of growth was down to 1.3 per cent; and for the period November 29-May 15, the annual rate was 4.6 per cent. While May as a whole may show inflows of time deposits at commercial banks somewhat greater at an annual rate than were registered last month, the growth probably will be well below that for the December-April months.

Both the rate of growth and composition of bank credit have varied significantly in the last few months. As shown in Table 2, total loans and investments at commercial banks rose at an annual rate of 7.2 per cent during the five months ending in April. This increase was just over three-fifths of the gain in 1967 as a whole and also somewhat below the pace of expansion in the early months of credit restraint two years ago. As one would expect during a period of heavy Treasury borrowing, the behavior of total bank credit has been

Table 2. Annual Percentage Rates of Change in Bank Credit for Selected Periods

Series - Seasonally Adjusted	Year 1965	Dec.65- Apr.66 ^{1/}	Year 1966	Year 1967	Dec.67- Apr.68 ^{1/}
Bank loans and investments	10.2	8.3	5.7	11.5	7.2
U.S. Gov. securities	-5.6	-7.6	-6.3	11.0	-10.1
Other securities	15.8	10.9	6.5	26.1	12.3
Total loans	14.7	12.5	9.1	8.2	10.6
Business loans	18.8	16.1	13.3	9.8	12.7

^{1/} Dates are inclusive

greatly influenced by changes in banks' holdings of U.S. Government securities. In February, the banks substantially enlarged their Government portfolios, but sizable liquidation of such securities occurred in March. The result was a rapid rise in total loans and investments in January-February followed by a moderate decline in March.

In April and in the first half of May, the growth of bank credit has centered in loans rather than in investments. The expansion in business loans was especially rapid in April as a whole, but some weakening has been evident since the mid-April tax date. Loans to business increased at an annual rate of 12.7 per cent during the December-April months of 1967-68, or roughly four-fifths of the

expansion recorded in the same months of 1965-66. The rise in business loans in April alone this year was at an annual rate of almost 20 per cent; in the first quarter, such loans climbed at an annual rate of 7 per cent compared with 10 per cent in the full year 1967. While direct tax borrowing by corporations (particularly outside New York City banks) accounted for a substantial share of the April rise in total bank loans, apparently a number of finance companies also borrowed heavily from banks to replace an unusually large volume of open market paper which corporations allowed to run off in order to meet their own tax payments. There was also a noticeable quickening in demand for loans by industrial and mining firms -- aside from borrowing for tax purposes.

In the last few weeks, however, there appears to have been some weakening in demand for business loans. This tapering off is evident in several areas, including primary metals, machinery and other fabricated metal products, textiles, chemicals and rubber, and mining. Available information is not yet sufficient to explain this moderation in loan demand. However, a few observations are possible. The heavy tax period borrowing in April would normally be followed by substantial loan repayments by some firms in early May. A large term loan was repaid recently by a chemical company. In the mining area (where a number of banks joined in April to supply funds for a large acquisition), there was also a large volume of repayments in early May. Holdings of bankers acceptances (which are included in the business loan statistics) have also declined rapidly in recent weeks.

But one should interpret these latest moderating trends in business loans with caution. Looking ahead over the next few months, it seems that the demand for business loans is likely to be strong rather than weak. The expected acceleration in inventory building certainly suggests that this will be the case. Moreover, if the surtax proposal is enacted in early June, corporations may borrow heavily around the middle of that month not only to pay current taxes but also partly to catch up on liabilities arising from both the retroactive feature of the bill and the provision requiring further acceleration in payment of corporate taxes generally.

The Dimensions of the Current Inflation

The inflation which monetary policy has been attempting to check actually has been present for nearly three years, although the pace has accelerated since mid-1967. . Its seeds were planted in mid-1965 when the expansion of military activity in Vietnam put additional burdens on an economy already on the eve of full employment. With the rapid growth in demand for goods and services for military purposes (unmatched by higher taxes to pay for the war), the Federal Government became a principal source of inflation in the United States.

The magnitude of the current inflation has been commented on quite widely, but it might be helpful to put the matter in perspective again. Perhaps the best way to grasp the dimensions of the inflation problem is to examine the composition of changes in gross national product (GNP) over the last few years. This is done in Table 3,

Table 3. Composition of Changes in
Gross National Product, 1964-1968

(Billions of dollars: seasonally adjusted annual rates)

Period	GNP (Current dollars)	Change in GNP (Current dollars)	Source of change in GNP		Composition of change in GNP (per cent change)		
			Domestic Demand	Net Exports	GNP (Current dollars)	Real Output	Prices
Year 1964	632.4	41.9	39.3	2.6	7.1	5.5	1.5
Year 1967	785.0	41.7	42.0	-0.3	5.3	2.6	3.0
First Quarter, 1968	826.7	19.4	20.7	-1.3	9.6	5.9	3.7

showing changes in GNP traceable to the growth of domestic demand vs. net sales abroad and changes in real output vs. changes in prices since 1964.

It will be noted that in both 1964 and 1967 the production of goods and services in the economy (as measured by GNP) expanded by about \$42 billion. However, in the later year, over half of the apparent gain actually reflected nothing more than the general rise in prices rather than an increase in real output. In contrast, although some inflation was also evident in 1964, almost four-fifths of the rise in GNP in that year represented an increase in real output. The expansion of GNP during the first quarter of this year contained a larger share of real growth than was the case for 1967 as a whole, but the inflation component was still nearly twice as large as in 1964.

Looked at from the perspective of the U.S. balance of payments, the domestic inflation has also been costly. In 1964, U.S. exports of goods and services rose by \$2.6 billion more than the increase in imports. This rise in net exports represented over 6 per cent of the increase in GNP and was clearly of substantial benefit to our balance of payments. By 1967, the situation had swung around completely. Last year, net exports of goods and services dropped by \$300 million compared with the year before, and there was a further relative decline during the first quarter of this year. Thus, the recent growth in domestic demand has outstripped the rise in domestic

output, with imports making up the difference. In other words, domestic inflation has had a major adverse impact on the U.S. trade account and on the balance of payments as a whole.

The spreading effects of inflation can also be traced in the more familiar measures of price changes. For example, in 1964 the consumer price index (CPI) rose by 1.3 per cent. In the first quarter of this year, the CPI rose at an annual rate of about 3.6 per cent. Wholesale prices, which registered little change during the years 1958-64, rose by over 5-1/2 per cent in the three years ending in 1967. The rise in durable manufactures (reflecting both military demand and a strong investment boom) was particularly large. The GNP deflator (perhaps the broadest measure of price changes we have) rose at an annual rate of over 3-1/2 per cent in the first quarter of this year, compared with 3 per cent in the full year 1967 and 2.7 per cent in 1966 as a whole

Until mid-1966, the rise in prices outstripped the increase in wages, so real income of wage earners actually declined. However, in the last two years, wages have risen rapidly -- partly in an effort to compensate for the previous increases in consumer prices and partly in response to the strong demand for labor generated by an economy operating close to the full employment ceiling. Fringe benefits and employment taxes are also significantly higher. At the same time, productivity has fallen considerably below the long-term annual increase of 3.5 per cent. The result is that, between the first quarter of 1966

and the first quarter of 1968, labor cost per unit of output in manufacturing climbed by almost 10 per cent.

Moreover, in the absence of further restraint on aggregate demand, there is no real prospect of checking inflation in the United States over any reasonable period in the future. The near-term outlook is for continued large increases in personal income and in consumer spending, the latter being augmented by a further decline in the savings rate. Outlays on plant and equipment by business firms also seem destined to register modest gains in the months ahead, and inventory accumulation may also quicken. With the Federal budget continuing to run an enormous deficit, it seems obvious that the total demand for goods and services will continue to exceed the capacity of the economy to meet it without adding further to inflationary pressures. In the face of this prospect, the need for more restraint also seems obvious.

Differential Impact of Monetary and Fiscal Restraint

In the judgment of a really remarkable consensus of economists, bankers, businessmen and public officials, the best way to achieve the required moderation in domestic demand is through a policy of vigorous fiscal restraint. I fully share this view. Because of a number of vital considerations, it makes a great deal of difference whether the additional restraint comes through fiscal policy rather than through monetary policy. The main characteristics of the differences in the impact on the economy of the two policy approaches are generally known. However, it might be helpful to sketch the broad outlines here.

It will be recalled that last January, the Council of Economic Advisers (CEA) estimated that GNP in 1968 would approximate \$846 billion -- if the President's fiscal program were enacted early in the year. This would represent a gain of about \$61 billion, with real output increasing somewhat more than 4 per cent and prices advancing somewhat more than 3 per cent. With the civilian labor force expected to grow by 1-3/4 per cent, the anticipated rise in output would be sufficient to maintain the unemployment rate in the neighborhood of 3.7 per cent.

The economic outlook for this year as CEA foresaw it becomes clearer when viewed in terms of the principal expenditure sectors -- again on the assumption that the 10 per cent surtax would be adopted early in the year. Perhaps the most important area is homebuilding. Private nonfarm housing starts were expected to exceed 1½ million units

in 1968, compared with 1.29 million in 1967 and 1.17 million in 1966. Expenditures on residential construction (which amounted to \$24.4 billion last year) were expected to increase by \$5 to \$6 billion. Thus, it was anticipated that homebuilding would continue to show a substantial recovery from the low level of activity registered in 1966. The Council recognized that this expected outcome would depend heavily on the avoidance of severe monetary restraint during 1968. Consumer outlays for goods and services other than housing were expected to rise about \$33 billion during the current year. The Council thought that -- even after taking account of both existing income taxes and the proposed surtax -- disposable personal income would increase by approximately \$35 billion, and the savings rate (which rose from 5.9 per cent in 1966 to 7.1 per cent in 1967) would remain essentially unchanged.

In the business sector, CEA foresaw a moderate expansion of about \$4 or \$5 billion in fixed investment during 1968. Such a gain would be about double that recorded last year. Business inventories, which expanded by \$5.2 billion in 1967, were expected to rise by several billion dollars faster during the current year.

State and local governments, CEA thought, would probably increase their purchases of goods and services by \$8 or \$9 billion in 1968. In this area, also, the Council recognized that the ability of these governmental units to raise their expenditures would depend on the existence of financial conditions which would allow them to proceed with their planned construction projects.

For present purposes, the really critical assumptions in CEA's outlook applied to the Federal Government. In calendar year 1968, it was estimated that Federal expenditures would rise by around \$15 billion, compared with a gain of \$21 billion last year. Purchases for national defense (including military pay increases) were scheduled to rise by \$4 billion, in contrast to \$12 billion in 1967. An increase of \$3 billion in social security benefits was set for the spring of 1968, which would be partly offset by a \$2 billion rise in payroll taxes effective next January 1. Aside from the scheduled changes in social security benefits, the other projected increases in Federal expenditures would be about matched by the normal yearly rise in Federal revenues at existing tax rates. Consequently, in the absence of tax rate increases, the Federal budget deficit (on a national income basis) in 1968 would be about the same or slightly higher than the \$12½ billion recorded in 1967.

Because such a deficit would continue to provide more stimulus to aggregate demand than the economy could absorb readily without adding further to inflationary pressures, the President recommended the enactment of the temporary 10 per cent surcharge on personal and corporate income taxes, effective January 1 for corporations and April 1 for individuals. The surtax was expected to yield about \$8 billion of additional revenue in 1968. The extension of several excise taxes (scheduled to lapse in April) would maintain another \$2 billion of revenue which otherwise would be lost. The combined impact of these revenue measures would reduce the Federal deficit to approximately

\$5 billion in calendar year 1968. While still expansionary, the Federal budget -- with the tax increase -- would be a substantially smaller source of inflationary pressures in the current year.

So much for the economic outlook on the assumption that a major share of the needed restraint on aggregate demand in 1968 would come through fiscal policy. Now we can ask the question: if the surtax proposal or a sizable reduction in Federal expenditures is not adopted by Congress, what would be the effects on the economy of attempting to moderate inflationary pressures through monetary policy? This question cannot be answered with precision, but the differential impact of the two policy approaches can be outlined. At the same time, it is necessary to keep in mind that the effects of monetary policy actions are normally delayed, and autonomous developments (unrelated to policy moves) also frequently influence the actual behavior of the economy.

In general, against the background of the monetary restraint introduced since last November, and on the basis of projections recently made by the U. S. Department of Commerce, it seems that GNP might amount to about \$850 billion in 1968. At this level, GNP would show a rise some \$4 billion above that anticipated under conditions of additional fiscal restraint. The share of the gain representing real output would be somewhat less and that representing price increases somewhat larger. The unemployment rate (in the neighborhood of 3.7 per cent) might be about the same, or slightly higher, but the civilian labor force would probably expand by less than it would with a more

balanced increase in output.

In the homebuilding area, the level of private nonfarm housing starts will undoubtedly fall short of the $1\frac{1}{2}$ million or more units anticipated by the CEA for 1968 as a whole. In the first quarter of this year, housing starts averaged 1.49 million, at a seasonally adjusted annual rate, with March alone registering a slightly higher figure. In April, the annual rate jumped to 1.62 million units. However, because of the volatility of this series, one must always interpret changes in a single month with considerable caution. In view of the slowing in mortgage commitments which began to appear before the end of last year, the annual rate may ease off considerably in the months ahead. By just how much homebuilding will actually be moderated during the rest of this year will depend substantially on the course of market interest rates and the inflow of funds to savings and loan associations and mutual savings banks -- the principal sources of home finance. But, on balance, it appears most unlikely that the increase of nearly 300 thousand in new housing starts which CEA foresaw for 1968 would be realized if further monetary restraint is required. Consequently the expected gain of \$5 to \$6 billion in expenditures for residential construction in 1968 most likely would also not be realized -- with the short-fall perhaps amounting to as much as \$3 billion.

On the other hand, disposable personal income would rise by some \$5 to \$6 billion more in 1968 than it would if the surtax were in force. With some further decline in the savings rate, consumer

expenditures would probably climb by an additional several billion dollars, with a particular stress on increased purchases of durable goods.

Outlays for business fixed equipment, which CEA thought might rise by \$4 to \$5 billion with the surtax on the books, might expand somewhat more rapidly. The rate of inventory accumulation would also be somewhat faster -- without the tax increase. Thus, while monetary restraint could be expected to have a moderating effect on investment expenditures in the business sector, it would be less than that exerted by fiscal restraint. In contrast, State and local governments might expand their purchases by \$200-\$300 million less than they would if more general restraint came about through fiscal rather than monetary policy.

Again, of course, the really big difference (almost by definition) between the two policy approaches to restraint would be registered in the impact of the Federal Government on the economy. As mentioned above, on a national income basis, in the absence of a tax increase, the Federal deficit in 1968 would be well above the \$12-1/2 billion recorded for 1967. In fact, it may well exceed \$13 billion. Under these circumstances, there would continue to be a sizable transfer of resources from the private to the public sector -- but without a matching transfer of revenue to pay for them. Instead, the Federal Government would have to continue its massive borrowings in the capital market (adding to the pressure on interest rates) while expanding aggregate demand which is already excessive.

All of us should find this prospect unacceptable. The proper remedy for it is the early adoption of a vigorous policy of fiscal restraint.

Coordination of Monetary and Fiscal Policy

Having argued that the outlook for the economy is far from comfortable in the absence of additional fiscal restraint, let me stress again that the task for monetary policy also remains critical. Clearly, the continued failure to adopt the proper fiscal measures would mean that monetary policy would remain virtually the only active force in the campaign against inflation. None of us should have any illusions whatsoever about the implications of following such a course. The expansion of bank reserves (whether provided by the System or borrowed by member banks) would have to be kept quite modest. The growth of bank credit and the money supply would have to remain under considerable restraint. Given the strong demand for funds which undoubtedly would exist during the rest of this year, interest rates and market yields would obviously remain under pressure.

In such an environment, inflows of funds to financial institutions -- to commercial banks as well as to savings intermediaries -- would undoubtedly shrink considerably. In fact, actual outflows into market instruments might occur on a noticeable scale. But, unlike the case in 1966 when strong competition of commercial banks for savings and time deposits created serious problems for S&L's and mutual savings banks, the difficulties this year might arise primarily from the pull

of market yields. It should be recalled that since September, 1966, the bank supervisory agencies have had authority to set maximum rates of interest payable on deposits and savings capital in such a way as to dampen competition among the different types of institutions. On the other hand, the inflow of funds to all three types of depositaries has slackened considerably in recent months. In fact, commercial banks experienced sizable attrition in their passbook savings in April, while between mid-March and mid-April their negotiable CD's outstanding in denominations of \$100,000 and over declined by \$1.5 billion -- partly reflecting the liquidation of such paper by corporations in order to pay taxes. Although the banks as a group have been about holding the level of CD's nearly constant since the rate ceiling was raised in April, there is little prospect that they will register any appreciable gain in the months ahead. There is also little likelihood that S&L's and mutual savings banks will make any headway in competing for funds against market securities offering particularly attractive rates of return.

In my personal judgment, if such financial conditions actually develop, the present structure of interest rate ceilings on consumer savings deposits and accounts may well have to be adjusted, and even so thrift institutions would still find it hard to compete against the rates available on market instruments. In the absence of additional fiscal restraint I am convinced that the issue will become pressing.

But, I am certain everyone is asking, what is the role of monetary policy if a vigorous program of fiscal restraint is adopted in the near future? Obviously, I cannot forecast what course the monetary authorities will pursue. As mentioned at the outset, the serious deficit in the balance of payments as well as the dimensions of the domestic inflation will clearly impose a constraint on the options available to the managers of monetary policy.

On the other hand, I am personally persuaded that a sufficiently strong program of fiscal restraint -- adopted relatively soon -- would open the way for a better mixture of stabilization policies. Such a mixture would contain a lessened degree of monetary restraint. Exactly how much relaxation might be possible is clearly the critical point. One would normally anticipate that passage of a tax bill would have a favorable effect on market expectations, resulting in some improvement in securities prices and some decline in market yields. The extent to which bank reserves could be expanded to help validate such changed expectations is a matter which we will clearly have to weigh carefully.

Looking ahead through the rest of this year and into 1969, we must keep in mind that the combined impact of the proposed fiscal actions and monetary restraint would have a progressively dampening impact on the economy. This will be reinforced by the rise in social security taxes effective next January. Such a progressive dampening is exactly what the economy needs. At the same time, however, we must also remain alert to see that the rate at which excess demand is

brought under control is kept orderly. Without attempting to assign the blame for it, I think it must be admitted that inflation has progressed a considerable distance. Thus, it will require some time before it is brought under control. It is vital that we achieve this objective without creating rates of growth in output so low -- and unemployment rates so high -- that the cost of checking inflation would be unacceptable to the vast majority of the nation's population. But, precisely because it will take some time to bring price increases back to a more tolerable pace, it is imperative that we get on with the task through the early adoption of more fiscal restraint.

Given the constraints imposed on policy actions by the necessity to see that the financial system (including our seriously deficient arrangements for home financing) is kept in reasonably good working order and to see that fluctuations in output and employment are kept moderate, I think we really cannot avoid a flexible approach to the management of monetary and fiscal policy. In my judgment, it is far preferable that public policy instruments -- although they may have to be changed from time to time -- be required to respond to changing circumstances than that the economy itself be allowed to swing widely under the impact of autonomous shifts in the composition and rate of growth of private demand. In this approach to national stabilization policies, neither monetary nor fiscal policy can remain frozen. So, as the situation requires, I am perfectly willing to support a change in monetary policy toward greater restraint or greater ease.

I would personally welcome an opportunity to confront such an option in the context of more fiscal restraint brought about by the early passage of the President's 10 per cent surtax proposal.