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MONETARY POLICY, CORPORATE FINANCING, AND THE QUEST FOR ECONOMIC STABILITY

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By
Andrew F. Brimmer*

As the current year has progressed, it has become increasingly evident that inflationary pressures in the American economy are much stronger than was anticipated even a few months ago. The implications of this unfolding evidence for national stabilization policies are quite clear: during 1969, we will need more overall monetary and fiscal restraint -- and it should last for a longer peroid of time -- than was foreseen at the beginning of the year. In recognition of this changed outlook for the economy, the Federal Reserve Board decided earlier this month to take further measures in the campaign against inflation. On April 3, approval was given for a 1/2 per cent increase in the discount rate to 6 per cent at Federal Reserve Banks, and reserve requirements against demand deposits at all member banks were raised by 1/2 percentage point, effective today. These moves will obviously help to dampen the rate of economic expansion during the rest of this year.

However, we should not hasten to conclude that these additional monetary measures, which reinforce the restrictive course of monetary policy followed since last December, will be sufficient unto themselves to bring the current inflation to an end. On the contrary, if we are to make significant progress toward checking inflation -- without imposing excessive strains

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* Member, Board of Governors of the Federal Reserve System. I am grateful to several members of the Board's staff for assistance in the preparation of these remarks -- particularly to Miss Eleanor J. Stockwell and Miss Mary Ann Graves.

on our financial system -- it is clear that the Federal Government's fiscal policy must also carry a greater share of the burden. Fortunately, in the light of the recently announced outlines of the budget for the next fiscal year, this need is recognized in the Executive Branch. If the sizable projected budget surplus materializes, Federal fiscal policy would become a powerful factor supporting the efforts to restore price stability. On the other hand, we should keep in mind that the impact of budgetary measures on the economy will be felt only after Congress has completed its actions and appropriated funds (including old as well as new authorizations) are actually spent. Given the recent experiences in this regard, it would seem wise to reserve judgment on the ultimate contribution that fiscal policy will make in the quest for economic stability in the months ahead.

In the meantime, the exceptional strength which the private sector is exhibiting poses a serious challenge to stabilization policies. Spurred by a large increase in plant and equipment expenditures, the corporate business sector has become a major source of excess demand and additional pressure on prices. To help finance the projected expansion in capacity, corporations may try to raise a sizable volume of funds during coming months and thus aggravate already difficult capital market conditions. Given this outlook, we should be prepared to adjust our stabilization policies to cope more effectively with the main sources of inflationary pressures in the year ahead.

However, in attempting to moderate the capital goods boom -- which is currently the mainspring of the renewed pace of expansion -- we should avoid taking measures which might disrupt the development of the economy in the long-run. In particular, in my personal opinion, it would be unwise to suspend the 7 per cent investment tax credit as some observers are suggesting. On the other hand, if the excessive rate of business investment in fixed equipment is not dampened by the monetary and fiscal actions already taken -- plus the budgetary measures in prospect -- I believe careful thought should be given to extending the 10 per cent income surtax through the next fiscal year at a rate for corporations higher than that applicable to individuals. I will comment further on this possibility in the closing section of these remarks.

Vigor of Economic Expansion

In the last month or so, expectations about the outlook for the economy during 1969 have shifted substantially -- toward expectation of a faster rate of growth and less progress in checking inflation. In late January, gross national product (GNP) in current prices for 1969 as a whole was projected in the range of $918 billion to $920 billion. This projection implied a year-to-year rise of about $60 billion (or 6.8 per cent), compared with an increase of $71 billion (or 9.0 per cent) during 1968. The rate of increase of the general price level (as measured by the GNP implicit price deflator) was projected to decline steadily through the year, and (after adjustment for the third quarter Federal pay raise) the annual rate of increase was expected to be around 3 per cent in the closing months of 1969 -- in contrast to roughly 4 per cent in the corresponding months of last year.

By the end of March, it was evident that the growth of the economy was not moderating as expected. In fact, as more information about spending plans in the private sector became available, it was necessary to revise upward the projections of overall economic performance during the current year. The key development underlying the more optimistic outlook is the sharp increase (about 14 per cent) in plant and equipment outlays planned by the business sector for 1969.

Although no detailed revisions can be made in the projections of GNP and its components until the new Federal budget estimates for fiscal year 1970 are available and have been digested, it is already clear that the rate of growth of the economy during calendar 1969 will be higher than was anticipated in January. As of today, despite the additional measures of monetary restraint adopted two weeks ago, the projection of even a slightly larger increase in GNP may well be warranted. In January, the quarter-to-quarter increases in GNP were expected to be in the range of $11 billion to $13 billion, suggesting seasonally adjusted annual growth rates of 5 to 6 per cent. Now it appears that the quarterly rises in GNP may be even higher. Under these conditions, the trend of prices during 1969 would still be downward, but the extent of the decline would be less than expected as the year began. By the fourth quarter, the GNP deflator may still be rising at an annual rate of 3-1/2 per cent -- against just under

3 per cent projected in January, and 1969 as a whole may register a price gain as large as that recorded in 1968.

Impact of Monetary Restraint

It was against this background of a quickening pace of economic activity that the Federal Reserve Board adopted additional measures of monetary restraint earlier this month. Prior to these moves, monetary and credit conditions had changed substantially in response to the shift in policy which occurred last December. During the first quarter of this year, nonborrowed reserves of member banks declined at an annual rate of 0.5 per cent, compared with an annual rate of increase of 3 per cent in the final three months of 1968. Because member bank borrowing at Federal Reserve Banks rose further, total reserves expanded at an annual rate of 0.9 per cent during the first quarter -- in sharp contrast to an 8.8 per cent annual rate of growth in the fourth quarter.

This pressure on bank reserves was accompanied by very little growth in private demand deposits and a sizable decline in time deposits at commercial banks.

Rising money market rates focused considerable pressure on large banks, as the maximum interest rates payable on large denomination certificates of deposit (CD's) became increasingly noncompetitive as yields on market instruments rose further. From mid-December -- when heavy CD attrition began -- to late March, weekly reporting banks lost nearly

$5.5 billion in CD's. About 55 per cent of this decline occurred at banks in New York City. Partly in response to this CD attrition, banks with foreign branches borrowed heavily in the Euro-dollar market. By the end of March, head office liabilities to foreign branches had risen to just under $10 billion, an increase of nearly $3.0 billion over the average December level.

Inflows of consumer-type time and savings deposits at weekly reporting banks declined in January -- following the year-end interest crediting period. However, these inflows expanded moderately in February and picked-up markedly in March. Flows of regular savings deposits accounted for this pattern -- declining sharply in January, remaining unchanged in February, and expanding substantially in March -- since inflows of time certificates and open accounts remained at a fairly steady pace over the first quarter of 1969. For all commercial banks, total time and savings deposits declined at a 6.7 per cent annual rate during the first quarter of 1969. (See Table 1.) Inflows of funds to nonbank savings institutions slowed only slightly in the early months of the year, probably in part because a substantial number of interest-sensitive depositors had already shifted their funds out of these institutions in response to earlier interest rate increases.

Again, reflecting the pressure on bank reserve positions, combined with high and rising market rates of interest, private demand deposits increased at only a 1.1 per cent annual rate over the first quarter. The money stock (which includes currency in the hands of the public as well as

Table 1. Changes in Commercial Bank Credit, Money Supply and Time Deposits
(Seasonally adjusted annual rates, per cent)

Category	1968		1969	
	Year	Fourth Quarter	First Quarter	March
Total loans and investments	11.0	10.4	1.5	- 2.5
U.S. Government securities	3.4	-14.4	-29.8	-14.5
Other securities	14.8	20.9	5.7	8.5
Total loans	11.9	13.9	7.9	- 2.8
Business loans	9.7	12.2	14.4	4.9
Money supply	6.5	7.6	2.3	2.5
Time and savings deposits at all commercial banks	11.3	15.7	- 6.7	- 0.6

private demand deposits) rose at a 2.3 per cent annual rate in the first quarter, or about one-third the rate of growth over 1968 as a whole. U.S. Government deposits at banks also rose in this period. Nevertheless, the decline in time and savings deposits more than offset the rise in demand deposits, and total member bank deposits declined at an annual rate of about 5 per cent during the first quarter.

In view of these deposit outflows, banks made significant adjustments in their security portfolios in order to accommodate continued strong loan demands. In the first three months of 1969, banks liquidated $4.6 billion in holdings of U.S. Government securities, mainly Treasury bills. Moreover, they cut back sharply on the acquisition of other securities, with large banks (which felt the brunt of the CD attrition) actually reducing holdings of these securities, particularly short-term municipals and Federal Agency issues.

The continued strength in loan demand reflected mainly borrowing by businesses, although demand for real estate credit also maintained the advanced pace of late 1968. Business loans expanded at an annual rate of over 14 per cent in the first quarter, compared with an annual rate of about 12 per cent in the fourth quarter of last year. The increases in business loans in the January-March months probably reflected in part borrowing to finance working capital needs associated with expanded plant and equipment expenditures. Security loans declined sharply further as dealers continued to reduce their positions from the high levels reached in the summer and early fall of 1968.

The impact of monetary restraint, in the face of continuing strong demands for credit, can also be seen in the behavior of interest rates. During the first quarter, most interest rates rose to new highs. For example, the Federal funds rate rose to about 6.85 per cent near the end of March, or about 60 basis points above the December high. Moreover, with loan demands at banks still strong, banks raised their prime lending rates further, to 7 per cent in early January and to 7.50 per cent in mid-March. In addition, banks with foreign branches relied heavily on the Euro-dollar market for funds, pushing rates on 3-month maturities, for example, to over 8.50 per cent by the end of March, or about 120 basis points above the December high. However, Treasury bill rates fell during the first three months of 1969 -- in spite of large sales of bills by both banks and dealers -- in response to heavy demands for these instruments, probably in large part reflecting shifts of funds from CD's to bills, although uncertainty as to interest rate and stock market developments may also have generated some demand for bills. Market rates on 3-month Treasury bills, for example, fell to around 6 per cent near the end of March, or about 20 basis points below their December peaks.

Pressure on bank reserve positions also spilled over into long-term capital markets. Yields on long-term Government bonds rose by about 20 basis points to a level of around 6.25 per cent during this period. By the end of March, yields on municipal bonds, Aaa corporate new issues (with 5 year call protection), and FHA mortgages all had risen about 45 basis points above their December highs, reaching levels of 5.30 per cent, 7.31 per cent and 8.11 per cent, respectively.

Intensification of Monetary Restraint

As I mentioned above, despite the substantial restraint on money and credit brought about since the end of 1968, the Federal Reserve Board concluded on April 3 that the campaign against inflation called for additional steps. These were taken -- involving an increase in the discount rate at Federal Reserve Banks from 5-1/2 to 6 per cent and an increase of 1/2 percentage point in reserve requirements against demand deposits. At the new level, the discount rate is the highest in 40 years -- although in 1920-21 the rate was as high as 7 per cent.

The increase in reserve requirements against demand deposits became effective April 17 and is applicable to average deposits in the period April 3-9 inclusive. The increase was distributed among classes of member banks as follows (millions of dollars):

All Member banks	$660
New York reserve city banks	124
Other reserve city banks	262
Country banks	274

The new reserve requirements at reserve city banks are 17 per cent on net demand deposits under $5 million and 17-1/2 per cent on deposits over $5 million. For all other member banks, the new requirements are 12-1/2 per cent on deposits under $5 million and 13 per cent on those over $5 million. No changes were made in reserve requirements against time deposits.

As member banks adjust to these higher requirements against demand deposits, their ability to expand credit will be lessened considerably. While it may be necessary to use open market operations to cushion the adjustment of the banks to the higher reserve requirements, one should not conclude that the increase of $660 million in required reserves will be fully offset by Federal Reserve purchases of Government securities. Requirements were raised for the purpose of absorbing reserves, and I -- personally -- would expect to see the effect clearly registered in non-borrowed reserves of member banks. It might be observed that, in raising reserve requirements, the Board applied the higher requirements to all member banks; it did not exempt small banks with net demand deposits under $5 million. During recent years, it had taken such a step when reserve requirements were changed on either demand or time deposits. These earlier exemptions were aimed at lessening the competitive disadvantage reserve requirements impose on small member banks compared with nonmember banks of similar size. In the present circumstances, where the aim is to reduce the growth of bank credit in the effort to check inflation, an exemption of any member banks from the higher reserve requirements seemed inappropriate.

The need to insure that monetary restraint reaches all banks -- and not simply the large money market banks -- is illustrated in the data in Table 2, showing changes in loans and investments by class of bank since last December, compared with changes in corresponding periods over the last three years. It will be noted that, between mid-December, 1968, and mid-March, 1969, total loans and investments of all member banks declined by $2.4 billion. In roughly the same period a year earlier, their loans and investments had risen by about the same amount. Even more striking is the experience of New York reserve city banks: in the three months ending in mid-March, their total loans and investments declined by $3.4 billion,

TABLE 2

LOANS AND INVESTMENTS BY CLASS OF BANK
(All data are for Wednesday dates, without seasonal adjustment, in billions of dollars)

	Levels		Change	Changes in corresponding periods ending		
	12/11/68	3/12/69	3 mos.	3/27/68	3/29/67	3/30/66
Loans and Investments						
All member	321.1	318.7	-2.4	+2.3	+6.9	+0.7
NY Reserve City	57.3	53.9	-3.4	-0.9	+1.2	-0.4
Other Reserve City	130.7	130.3	-0.4	+1.1	+3.6	-0.6
Country	133.1	134.5	+1.4	+2.1	+2.1	+1.7
U.S. Gov't. Securities						
All member	48.7	42.7	-6.0	-1.2	+2.5	-2.9
NY Reserve City	6.7	4.6	-2.1	-0.7	+0.8	-0.7
Other Reserve City	17.0	14.4	-2.6	-0.3	+1.5	-1.6
Country	25.1	23.8	-1.3	-0.2	+0.2	-0.6
Other Securities						
All member	56.2	56.4	+0.2	+2.1	+3.2	+0.5
NY Reserve City	8.0	7.5	-0.5	+0.4	+0.4	-0.6
Other Reserve City	22.5	22.0	-0.5	+0.5	+1.9	+0.3
Country	25.6	26.9	+1.3	+1.2	+0.9	+0.8
Total Loans*						
All member	216.2	219.6	+3.4	+1.5	+1.2	+3.0
NY Reserve City	42.7	41.9	-0.8	-0.6	--	+0.9
Other Reserve	91.2	93.8	+2.6	+1.0	+0.1	+0.7
Country	82.4	83.9	+1.5	+1.1	+1.1	+1.4
Business Loans	(12/11/68)	(4/2/69)		(4/3/68)	(4/5/67)	(3/30/66)
All weekly reporters	71.7	75.2	+3.5	+2.9	+1.5	+3.5
NY weekly repoters	23.7	24.5	+0.8	+1.2	+0.7	+1.5
Other weekly reporters	48.0	50.7	+2.7	+1.7	+0.8	+2.0

* - Includes loans to banks.

against a decrease of only $900 million in the comparable period of 1968. In other words, while reserve city banks in New York held less than one-fifth of the total loans and investments held by all member banks in mid-December, 1968, the drop in the dollar amount of their holdings during the following three months was almost 1-1/2 times as large as that for member banks taken as a group. In contrast, other reserve city banks experienced only a modest decrease in their loans and investments, and country banks registered an actual expansion. A similar story is told by other data in the table: the heaviest burden of monetary restraint through mid-March -- in both absolute and relative terms -- had fallen on the largest banks.

Other evidence (not shown in Table 2) suggests that the same pattern extended through March as a whole. For example, at large banks, credit rose less than usual in March and declined much more than usual over the January-March period. On the other hand, at small banks, the increases in earning assets were more than usual in March and were about in line with first-quarter changes for other recent years. Loan expansion in March, as well as for the entire first quarter, was much less than usual at large banks -- but somewhat more than usual at small banks. In the case of investments, bank holdings of municipal and Federal Agency issues increased moderately in March -- bringing the annual rate of growth for the first quarter to about 6 per cent, compared with over 20 per cent in the fourth quarter of 1968. However, the slowdown occurred at large banks who reduced their holdings contra-seasonally over the January-March period. Declines in holdings of both short- and long-term municipals were sharp, and reductions also occurred in holdings of participation certificates and Federal Agency issues. In contrast, small banks continued to acquire securities at a pace well above that in the comparable periods of other recent years.

Thus, in my opinion, the need to redistribute some of the burden of monetary restraint within the banking system was clearly evident. At the same time, there was no need to relieve the overall pressure of restraint on any segment of the system by providing greater leeway to compete for funds through the ability to offer higher rates on various types of time deposits. Rather, as stressed above, the fundamental need at the end of March was for more -- not less -- overall restraint. The steps taken in early April were directed to that end.

The Boom in Business Investment

As I mentioned above, the projected rise in business fixed investment during 1969 is the principal reason why the current inflation will be prolonged.

The latest survey of anticipated business capital spending (conducted periodically by the Commerce Department's Office of Business Economics and the Securities and Exchange Commission) suggests a rise of 14 per cent in plant and equipment outlays in 1969. The survey was conducted in late January and early February and announced in the middle of March. If these plans were fulfilled, business spending for new facilities would rise this year by $9 billion to a total of $73 billion. Such a rapid expansion would be in sharp contrast to the 4 per cent advance recorded in 1968 and the rise of 2 per cent in 1967. Apparently, the projected increase rests on a number of motivations -- including an expectation of large sales gains in 1969, the improved earnings position in 1968, efforts to expand capacity to meet long-run demand, and the desire to substitute capital for labor wherever possible.

The OBE-SEC survey indicates that the projected rise in capital outlays is broadly based, with manufacturing industries expecting a gain of 16 per cent, and the nonmanufacturing sector expecting an increase of 12 per cent. Although some of the anticipated advance in plant and equipment outlays may not be realized (and some of the projected increase reflects higher prices rather than real investment), the planned increase still represents a substantial rise in private claims on resources at a time of serious inflation. Furthermore, the sizable expansion is projected despite the fact that the capacity utilization rate in manufacturing averaged 84 per cent during the second half of 1968 -- well below the preferred rate of 90-92 per cent.

While one might expect some short-fall between projected and actual outlays on fixed equipment, there is also a good chance that plans may be realized substantially -- unless public policy is brought to bear. This was certainly the case during the 1966 fixed investment boom. In November, 1965, the OBE-SEC survey indicated that plant and equipment outlays during the second quarter of the following year were projected to show an increase of 14 per cent over the annual average for 1965. By the time of the March, 1966, survey, such outlays were projected to show an increase of 16 per cent during the full year over the 1965 level. The actual increase in 1966 was 16.7 per cent. Thus, during a period of strong business anticipations, the projected increases in plant and equipment expenditures indicated in the OBE-SEC survey may understate actual outlays.

It is too early to tell just how successfully the business community is carrying out its investment plans in 1969. However, as the year got underway, it was expected that the increase in fixed investment would be particularly sharp during the first quarter (perhaps as much as 13 per cent at an annual rate), with the pace declining steadily thereafter (to perhaps 4 per cent at an annual rate in the final quarter). For the year as a whole, the increase was projected at 10 per cent. By the end of March, the projection of the annual increase had been raised considerably -- to at least 12 per cent. The sharpest advance (at an annual rate of around 18 per cent) was still expected to occur in the first quarter, with a downtrend thereafter. However, by the fourth quarter, the pace of expansion was projected at almost 8 per cent -- nearly double the rate projected in January.

Some indirect evidence suggests the pace of business fixed investment, in fact, was quite rapid during the first quarter of this year. The output of business equipment during the January-March months rose at a seasonally adjusted annual rate of 8 per cent. Since prices probably rose at an annual rate of 3-to-4 per cent during the same period, the expansion in current dollars was close to 12 per cent at an annual rate. Looked at in a somewhat longer perspective, the expansion in the output of business equipment in the first quarter of this year suggests that the investment boom is certainly strong. For example, in the first quarter of 1968, the seasonally adjusted annual rate of increase was 4 per cent; in the second quarter, a 1 per cent decline occurred, and this was followed by a gain of 2 per cent in the third quarter -- both at annual rates. In the final quarter, there was a sharp rise at an annual rate of 12 per cent, and this was followed by 8 per cent during the first quarter of 1969. Also, in the January-March months of this year, new orders for producers' durable equipment remained at the sharply advanced level of the final three months of last year; such orders were 16 per cent above the level recorded in the first quarter of 1968.

Again, these indicators suggest that investment in business fixed equipment is expanding at a rapid pace. On the other hand, the plans reported in the OBE-SEC survey were made before monetary policy became as restrictive as it is currently. Thus, actual spending should run lower -- and as corporations conclude that the monetary and fiscal authorities are fully committed to fighting inflation -- and in fact are making substantial progress -- business investment outlays undoubtedly will be reduced somewhat.

Corporate Demand for Funds

This rapid pace of business investment may generate a sizable increase in the volume of corporate borrowing in the securities markets.

This conclusion emerges with considerable clarity from an analysis of quarterly sources and uses of funds data relating to nonfinancial corporations for 1967 and 1968 and the first half of 1969. Figures for the fourth quarter of 1968 are still preliminary and those for 1969 must necessarily be rough estimates.

In general terms, the "gap" between internal funds of nonfinancial corporations and total outlays for fixed assets and inventories is projected to be even somewhat wider during the first two quarters of 1969 than the record gap of the fourth quarter of 1968. In the final three months of last year, preliminary estimates suggested that fixed investment exceeded internally generated funds by just over $21 billion at an annual rate; in each of the first two quarters of this year, the gap may be as much as $2 billion wider. Internal funds seem likely to change little, and the anticipated sharply higher level of plant and equipment outlays more than offsets the projected lower rate of inventory accumulation.

The nonfinancial corporate sector seems to have entered 1969 in a very favorable financial position. After several years of moderate growth, liquid asset accumulation is estimated to have spurted very sharply in 1968, reflecting high profits and cash flows and some borrowing in excess of current needs. A wide excess of tax accruals over payments added to internal fund availability in the first quarter of this year, and helped to hold external financing needs down. Through borrowing from banks and heavy reliance on the commercial paper market, many corporations refrained from high cost capital market borrowing. But, while the average pace of public bond offerings so far in 1969 has not been high, two factors about it are significant. Practically none of the recent offerings have been made by large industrial or financial firms. Instead, most have been by public utilities or by smaller corporations using convertibles.

The financial position of corporations now suggest, however, that large firms once again may have to tap the capital markets. It is likely that corporate liquid asset holdings have been, or soon will be, eroded. Reflecting the large April and June instalments, tax payments -- in contract to the first quarter -- are expected sharply to exceed tax accruals in the second quarter of 1969. This sharp turn around from the first quarter represents a substantial use of corporate funds. In addition, while profits are also expected to remain relatively high, increasing capital outlays are projected to widen the gap between internally generated funds and expenditures. All of these developments should lead to a greater volume of external financing.

Some market participants now think a few sizable industrial and finance companies are waiting for an opportune time to float bonds. While no one in the market apparently sees a near-term potential surge in the volume of issues coming to market, in contrast to market rumor earlier this year, some pick up in large offerings would not now be a surprise.

As stressed above, the market swing in income tax payments between the first and second quarter of 1969 (even after allowing for seasonal factors) implies that the further accumulation of liquid assets which probably occurred in the first three months would most likely be followed by much larger reductions in these balances in the second quarter. This further implies a considerable expansion in the demand for funds by corporations -- from banks as well as from the sale of market securities.

Moderating the Corporate Investment Boom

In my opinion, permitting such enlarged demands for funds to be validated -- and thus allow the plant and equipment boom to proceed at the projected pace -- would be inconsistent with our national objective of bringing inflation to an end. As I observed above, the monetary policy measures adopted earlier this month should make an additional contribution toward the achievement of this goal. Moreover, the tighter budgetary measures which seem in prospect for the coming fiscal year, as they actually materialize, should also be helpful.

However, if the strength of the capital goods boom turns out to be even greater than is anticipated even today, still other stabilization efforts might be required. Given this possibility, one must recognize that those observers who are criticizing the 7 per cent investment tax credit as an unnecessary stimulant to the acquisition of capital goods (and indirectly to the current inflation) and who are already calling for its suspension again, in fact, have a very strong argument on their side. Nevertheless, the off-on experience along this line in 1966-1967 provides little to encourage one to be hopeful about the beneficial results of such a move. It will be recalled that the initial plan to suspend the tax credit for 15 months, and to include a fairly wide range of capital goods within the scope of the suspension, turned out in practice to involve an actual suspension of only roughly five months -- and the types of investments to which it applied was narrowed considerably. In retrospect, it appears that by the time the suspension was finally approved, the crest of the wave of capital expansion had passed. As the emerging evidence suggested that the excessive rate of growth of output -- especially of investment goods -- and inflationary pressures were moderating in early 1967, a move to restore the 7 per cent tax credit was launched quickly, and Congress approved it fairly promptly.

Yet, despite this experience, there appears to be a growing movement in support of repeating the episode. Quantitatively, their case seems to be a strong one. In 1966 (the latest year for which corporate income tax data are available), the investment credit amounted to $2.0 billion dollars, or 5.8 per cent of the $34.8 billion of corporate income taxes for that year. In 1965, the investment tax credit amounted to $1.7 billion, or 5.4 per cent of the $31.7 billion of corporate income taxes. At the end of 1965, the amount of unused credit available to corporations totaled $1.2 billion. Although it is difficult to obtain a firm estimate, for the current year, the 7 per cent investment tax credit may be providing corporations with as much as $2.8 billion. Since this can be deducted from corporate taxes -- and not simply from investment outlays -- the incentive the tax credit provides to add to plant and equipment is obviously very strong.

Nevertheless, I still think it would be unwise to suspend the credit. In the long-run, we will probably need to encourage businesses to modernize their productive capacity to help maintain full utilization of our manpower resources. But in the short-run (and the next year may provide such an example), it may also be necessary to off-set the stimulation to output which the tax provides. If this need does materialize, it would seem preferable to pursue a course other than suspending the 7 per cent tax credit.

One such alternative would be to increase the 10 per cent income surtax applicable to corporations. If this tax were extended, and raised to 15 per cent, it might lift Federal revenue from corporate taxes by some $2 billion at an annual rate. During the fourth quarter of 1968, corporate profits before taxes were at an annual rate of $95.8 billion. Federal revenue from corporate profits taxes (including the effects of the 10 per cent surtax) during the same quarter was at an annual rate of $39.9 billion. And with corporate profits expected to remain high for 1969 as a whole, an increase in the corporate surtax by 5 percentage points would probably increase Federal revenue from corporate taxes by just over $2 billion at an annual rate.

If it were necessary to take further fiscal measures to moderate the investment boom, the above approach would yield a quantitative result of roughly the same magnitude as that which might be derived from the suspension of the investment tax credit for a full year. But -- unlike the tax credit route -- it would not involve a long delay in the transmission of the impact to corporate spending for capital goods. Because the higher surtax would mean a direct and known reduction in after-tax corporate profits, it could be expected to bring about a prompt reappraisal of business prospects. Since there is already a growing divergence between the rate at which businesses are expanding capacity and the rate of growth of demand (especially in the household sector), a modest decline in the expected profit rate, might be sufficient to induce numerous corporate officials to revise downward their own plans for expansion. Such downward revisions would clearly be more consistent with the national objective of bringing inflation to a halt.

Concluding Remarks

In the meantime, I am personally confident that monetary policy will continue to make its own (hopefully unequivocal) contribution in the quest for the restoration of economic stability. This must necessarily mean that a substantial degree of credit restraint will have to be maintained well into the future. Consequently, I personally would not encourage bankers and their customers to look forward to an early relaxation of Federal Reserve restraint on the rate of growth of bank reserves. On the contrary, the continuation of excessive inflationary pressures in the economy requires that bankers keep a close check on the rate at which they are extending loans or acquiring securities. To achieve this end, it is highly desirable that their new commitments to lend in the future be kept in check as well.

Frankly, I think virtually every one in the banking community realizes by now that the outlook is for a continuation of monetary restraint for quite sometime into the future. On the other hand, there still appears to be uncertainty about the degree of credit restraint which the monetary authorities are prepared to bring about. While I obviously cannot speak for my colleagues in the Federal Reserve System, I am personally prepared to pursue this policy as far as is necessary -- and for as long as is necessary -- to bring about a meaningful reduction in the pace of inflation. Thus, I am personally unprepared to give any assurances to bankers that they will not have to make some of the more painful adjustments in their existing asset structures (such as selling U.S. Government and other long-term securities at sizable capital losses) if their loan commitments greatly exceed their ability to meet them through the growth of deposits. I am certain that many bankers would define such a situation as a so-called "credit crunch". For the monetary authorities to give an assurance that any bank can liquidate large amounts of securities with only modest capital losses and to continue a rapid rate of loan expansion would be tantamount to a virtual abandonment of the policy of monetary restraint. Needless to say, I am not suggesting that I favor allowing disorderly conditions to develop in the Government securities market. Obviously open market operations would have to be used to forestall the emergence of such a situation. But there is a great deal of difference between such judicious purchases of Government securities (which can be offset by an increase in reserve requirements if necessary) and the guarantee of an opportunity for banks to sell such securities with little risk of capital losses.