

ON DIFFUSING THE IMPACT OF MONETARY POLICY

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The last time I appeared before the Downtown Economists Club was in 1962 or 1963. At that time we were dealing with an economy which had experienced chronic slack. The unemployment rate was 5 1/2% and there was a widespread feeling that automation was displacing so many jobs that we should not hope to get the rate much below 5%. We had stable prices and stable labor costs and a surplus on current account of between \$5 billion and \$6 billion, but we had a large balance of payments deficit because of a massive outflow of U. S. capital abroad.

We have come full circle in the past six or seven years, even to the point where the U. S. has become a net capital importer, a fact which the Kennedy Treasury Department (that is, John Kennedy's) would have found absolutely unbelievable.

I recite all of this simply to remind you that even the most deep-seated and seemingly irreversible trends can be reversed. In fact, it is probably a good rule of thumb that when something becomes generally recognized as being irreversible it is probably in the process of being reversed. You will all recall the flood of books on the "dollar gap" which came out in the late 1950's.

The particular irreversible trend which the Federal Reserve is now working to reverse is, of course, the inflationary trend of the past four years. In recent months I have been working hard to convince the New England financial community that we were really pursuing a very restrictive monetary policy. Until recently, I encountered a lot of skepticism -- much of which stemmed from the policy error of last summer. (The current theme-song of the Federal Reserve is that old Frank Sinatra ballad, "The Things We Did Last Summer.") The policy error was produced by a faulty economic forecast; but many people in the market refused to believe this explanation -- choosing to attribute it to a loss of will on the part of the Fed to deal with inflation.

But now that Salomon Bros. has officially declared that we are in a "credit crunch," which by their very useful definition is a period in which bank liquidity has been reduced to the point where bankers must ration credit, I thought I might safely turn to a different topic.

The subject of the allocative impact of a restrictive monetary policy is not a particularly hot subject now, but it might well become one in the months ahead as the full cumulative impact of monetary policy is felt in the marketplace.

It is axiomatic that, if a restrictive monetary policy is to be effective, some economic units must be restrained from some expenditures that they would otherwise have made. One can argue on grounds of equity that the

impact of policy should be broadly diffused throughout the economy. Ideally, one might envisage a system in which a restrictive policy cancelled out the marginal 1% of expenditures for each unit in the economy -- each consumer, each business organization, each unit of government. In such an ideal system, a restrictive monetary policy would be perfectly "neutral" -- it would lower the aggregate total of spending without altering the pattern of resource allocation.

It is unfortunate that such a "neutral" monetary policy is incompatible with the operation of free money and capital markets. In a free market, those sectors of the economy most heavily dependent on external credit, such as housing and the construction projects of state and local governments, are certain to be more inhibited by a tight money policy than sectors less dependent on external credit.

In addition, a restrictive monetary policy operating through free markets will have its greatest impact on those sectors which have the least flexibility with respect to credit sources, such as the housing industry, state and local governments, the small businessman and the consumer.

What this means, of course, is that the large corporate sector, which is not as heavily dependent on external credit as most other sectors of the economy and which has at its disposal the most sophisticated array of credit sources, will be least inhibited by a tight money policy. In the first instance at least, the burden of adjustment to a tight money policy

will be more severe for other sectors of the economy, and the burden will be particularly severe when, as in 1966, the Federal Government is also making large demands on the credit pool.

The Congress has become sensitive to the equity aspects of the allocation of financial resources under a restrictive monetary policy, and it is appropriate that it should. As the elected representatives of the people, we should expect them to be sensitive to signs of inequity wherever they might appear.

The equity problem tends to be dramatized by the fact that the conditions which generate a tight money policy are those which also give the large corporations an incentive to increase their investment spending. The economy is likely to be operating close to capacity, labor costs are likely to be rising, stimulating the demand for cost-reducing investments, and corporations, with profits at a high level, have a large cash flow to invest. In this sort of context, it is only natural that there should be complaints that the burden of monetary restraint is being borne by the small businessman, state and local governments and the housing industry, and that the large industrial corporations are getting away scot-free.

At present, the principal focus of Congressional concern is the housing industry. The Congress is particularly concerned that the current period of monetary restraint does not require the housing industry to undergo the massive adjustment which was required of it in 1966.

Reflecting this concern, measures have been taken to buffer both the housing industry and the financial organizations serving the housing industry from the full force of monetary policy. Both the Regulation Q ceilings and the aggressive operations of FNMA and the Federal Home Loan Bank System have helped to maintain a fairly steady flow of funds into mortgages thus far in 1969.

Two other factors have also helped considerably. The large, interest-sensitive deposits which made the savings and loan associations and the mutual savings banks so vulnerable in 1966 did not flow back into these institutions in 1967 and 1968 and, as a consequence, even interest rate differentials much larger than those which existed in 1966 have not produced major deposit drains. A second factor which has helped to maintain housing starts in 1969 is the fact that a growing percentage of starts is taking the form of apartments. Developers of apartment projects have more financial avenues open to them than the developers of single family residences, particularly if they are willing to offer an equity participation to the lender.

The very fact that the percentage of apartments in total housing starts is rising suggests that the impact of monetary policy on future housing expenditures is going to be greater than the trend in total housing starts might suggest. Nevertheless, at this point in time, one would have to conclude that the efforts to shield the housing industry and the mortgage

lending intermediaries from the full force of monetary policy have enjoyed a considerable success. While housing starts will undoubtedly drop from the current level, no one expects a repetition of the precipitous drop of 1966.

I am a bit concerned, however, that the major factor supporting housing in 1969 which we did not have in 1966 is usually not mentioned -- that is, a Federal budget in modest surplus. If we were to add to the current financial picture a major Treasury deficit, it is hard for me to believe that the flow of funds into housing could have been sustained no matter what else was done.

The success, thus far, of the efforts to shield the housing industry from the full rigors of a restrictive monetary policy, raises three basic questions which we ought to be pondering:

First, if we concede that the present structure of interest rate ceilings on deposits is a temporary expedient but not a permanent solution, what structural reforms can be introduced which will produce, through the market mechanism, a reordering of savings flows of the sort which will render a restrictive monetary policy more "neutral" in its impact?

Second, if monetary policy is rendered more "neutral", will this produce greater lags in the response of the economy to a restrictive policy?

Third, if monetary policy is rendered more "neutral" during its restrictive phase, will the economy respond more slowly to an expansionary monetary policy in any subsequent recession?

A great deal of thought is being given to the first question, but relatively little to the latter two, which ultimately could prove to be much more important.

With respect to the first question, in particular to the restructuring needed to buffer the housing industry from the full force of monetary policy, thinking is proceeding along two lines: on the one hand to restructure the non-bank financial intermediaries so that they would be in a better position to weather the rigors of a tight money policy and, on the other hand, to rechannel savings flows away from other uses toward housing through the intermediation of governmental or quasi-governmental agencies.

Clearly, a good case can be made for giving the non-bank intermediaries more flexibility with respect to the types of assets in which they can invest -- if only to give more policy freedom to the Federal Reserve. However, it is not clear to me that restructuring the savings and loan associations and the mutual savings banks so that they are more like commercial banks will lead to a more even flow of funds into housing. It could well have the opposite effect. Nevertheless, I think there is a very strong case for restructuring these institutions so that they can operate in a tight money environment without the protection of arbitrary deposit interest rate ceilings.

The ability of agencies such as FNMA to channel savings flows away from other uses into housing is limited. Much depends on the budgetary

position of the Treasury, since these agencies finance their operations by selling securities which compete directly with Treasury offerings. When the Treasury is in surplus and Treasury securities are relatively scarce, these agencies will find a reasonably receptive market for their securities. Under these conditions, which are the conditions of 1969, there is little reason to doubt that they are generating some net increase in the volume of funds available for housing. On the other hand, I have serious doubts that similar efforts produced any significant net increase in funds for housing under the conditions that prevailed in 1966, a time when the Treasury was also a heavy borrower.

If funds have been diverted to housing in 1969, what sectors have suffered? One sector is certainly the state and local governments, primarily as a consequence of the Regulation Q ceilings. If commercial banks were in a position freely to buy funds away from other intermediaries, I think they would be providing more support to the municipal bond market than they are today.

But I see no evidence that funds are being diverted away from investment by large business corporations and, short of a comprehensive and stultifying set of direct controls, I do not think such a diversion can be accomplished. This does not mean that monetary policy will not be effective in ultimately curbing business investment, but it does mean that its impact will largely be indirect rather than direct.

If it is desired to curtail business investment directly, tax policy and fiscal policy offer much more promising avenues for action than monetary policy. It is for this reason that I support President Nixon's proposal to repeal the investment credit. There will again be a time when an investment subsidy will be needed in the public interest. When that time comes, I hope that we will be able to devise a subsidy which can easily be removed when the level of private investment becomes a source of economic instability, as it is today.

You should have gathered by now that I am not sanguine that we can restructure our financial institutions in a way which will render monetary policy "neutral" in its impact. But assuming that we found a reasonable way to do it, are we really sure that we would like the results?

Would such a "neutral" monetary policy lengthen the lags in the response of the economy to a restrictive monetary policy? I am inclined to think that it would. Perhaps we can learn something about this question from the 1969 experience.

I think an even more disturbing question is whether such a "neutral" monetary policy would slow the response of the economy to an expansionary monetary policy in a recession. It is said that you can lead a horse to water but you can't make him drink. However, you can greatly increase the probability of the horse drinking if you make sure that he is thirsty when you bring him to the water.

We pride ourselves in our ability to control recessions, but we ought to be aware of the important role that housing has played in this process in the postwar years. The prompt response of housing to an improvement in the availability of funds has been due in large part to the fact that the industry has been financially starved during the closing phase of the boom. The housing horse was very thirsty and when led to water, he drank. It is reasonable to suppose that if this had not been the case, the response would have been less vigorous. The fact that housing investment has tended to move in a pattern which has been out of phase with business investment in the late stages of booms and the early stages of expansions has been a great stabilizing force in the economy, a source of stability which should not be surrendered lightly.

In conclusion, on purely theoretical grounds I would be concerned that if we were able to take steps which would render monetary policy "neutral", diffusing its impact evenly throughout the economy, we would, in so doing, weaken the effectiveness of monetary policy in dealing with both boom conditions and recession conditions.

However, as a practical matter, I am convinced that there are severe limits on the ability of the government to rechannel savings flows under a restrictive monetary policy. The extent to which the most sensitive sectors are hurt by such a policy will depend primarily on the proportion of the savings pool absorbed by the strongest claimants, the U. S. Government and the large corporations.

If this is the case, then the answer to the problem of the housing industry is to be found primarily in fiscal policy and tax policy rather than in restructuring our financial institutions.

When the economic history of 1969 is written, I think it will show that the factor which provided to the housing industry its best protection in an economy suffering from excess demand was not Regulation Q or FNMA of the Home Loan Bank System, but a Federal Government Budget in surplus.

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