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"CURRENT MONETARY POLICY"

While I have some fairly close knowledge of monetary policy in recent months, I cannot help but feel a bit uncomfortable about the topic: first, because I have had a hand in shaping it as a member of the Federal Open Market Committee; and secondly, because I am not very proud of the policy record as it unfolded during the second half of 1968.

What I would like to do in the brief time allowed me is to concentrate on monetary policy since November 1967. As most of you are aware, in November the Federal Reserve banks raised the discount rate shortly after the British devaluation. This action signaled a shift to a policy of greater restraint. Such a policy was believed by almost all of us in the Federal Reserve to be appropriate in view of the strength in the economy, Congressional delay in approving an income tax surcharge, and the growing feeling that the Federal Reserve stood alone in fighting inflation until Congress decided to act.

From then until the middle of 1968 (specifically, December 1967 - June 1968) the Federal Reserve earned good marks in achieving moderate and sustainable rates of growth in bank reserves and most of the monetary aggregates. Since there is disagreement among the experts about which indicator, or indicators, are the most appropriate guides to monetary policy, perhaps the best thing for me to do is to give you a rundown of the behavior of a few of the key financial variables over this period of monetary restraint. Total member

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bank reserves increased at an annual rate (seasonally adjusted) of about 5% in the first half of 1968, down from an 8-1/2% rate in the preceding six months. Nonborrowed reserves (total reserves less borrowed reserves; that is, reserves supplied at the initiative of the Federal Reserve System) increased at a rate of about 2%, substantially less than the 7% rate of gain recorded in the preceding six months.

Growth in time deposits slowed markedly in the seven months ended June 1968, rising at a rate of only 5%. In contrast, the narrowly-defined money supply increased at an 8% rate -- a development that has evidently created some confusion among "Fed watchers" and other observers who criticize Federal Reserve policy on the basis of the erratic behavior of certain monetary variables over which we have only limited control. To be specific, it is not possible to use the rate of growth in the money supply over short periods, or even reasonably long periods such as December 1967 - June 1968, as an indicator of the thrust of monetary policy. In that period, there was a massive shift of funds out of U. S. Government deposits into private hands because of the budget deficit, thus boosting the money supply in the short run.

Over the long term (in which at least some of us will be dead) such transfers of funds from Government hands to private accounts tend to wash out since they are caused by short-term fluctuations in the U. S. Treasury's cash position. But within any reasonably short period, these very natural transfers of funds produce wide fluctuations in the money supply, particularly in times of large Federal deficits. What I am suggesting is that, given our objectives and our need to pay close attention to current developments, the Federal Reserve

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System has less control over the money supply in the short run than many of our critics seem to believe. In fact, the narrowly-defined money supply (and to a lesser extent, the broader-defined money supply) is as much a result of Treasury action, and Congressional appropriations and tax policy, as it is of the Federal Reserve.

In view of some of these problems, many of us in the Federal Reserve System prefer to use another monetary variable as a general guide to Federal Reserve policy. This is the "bank credit proxy", a series that measures total member bank deposits against which reserves must be held, including deposits of the U. S. Treasury. The deposit side (rather than the asset side) of the commercial bank balance sheet is used, because reasonably reliable data on bank deposits are available on a weekly basis, with daily data from large banks. Thus, on the basis of frequent estimates of total deposits, we can adjust policy actions quickly if we seem to be going wide of the mark.

Total bank deposits are a reasonably good short-run proxy for total bank credit. The differences between the two sides of the balance sheet represent bank capital, which does not change frequently or substantially, and nondeposit liabilities such as borrowings from foreign branches. Information on borrowings from branches is also available and can be used to adjust the credit proxy. For this reason, many of us have turned toward a measure of the credit proxy adjusted to include Eurodollar borrowings, which have increased enormously in recent years, thus adding to the volume of funds available for banks to loan or invest. Both of the proxy measures provide more frequent readings of bank credit developments than does the monthly information on actual bank loans and investments. Let me hasten to add, however, that the credit proxies are not foolproof in short-run periods. For example, on the last day of February, data became available that indicated the actual annual rates of growth of the credit proxies were two percentage points over the rates projected earlier for the month. By then, it was too late for the System to affect the figures for the month.

Looking at the two measures of the credit proxy, what was the situation in the first half of 1968? In 1967 the unadjusted credit proxy increased at a very rapid pace of more than 11%. By comparison, in the policy period that ran from December 1967 through June 1968, the rate of growth in the credit proxy dropped to 3-1/2%, and even when Eurodollars are included, at an annual rate of only 5%. In other words, in the first half of 1968 the Federal Reserve System was successful in holding bank credit expansion to a modest rate. This policy of moderate restraint, in my opinion, was entirely appropriate. Nevertheless, serious economic imbalances remained that were beyond the reach of only six months of monetary policy. For example, the fiscal situation was still highly expansionary, and price inflation continued at an excessively rapid pace. But I think an unbiased appraisal would give us good marks on the period; monetary policy was appropriately restrictive in a period of growing inflationary pressures.

I wish that I could say the same for the second half of 1968. Early in July, monetary policy was reversed abruptly, as has been done too often, and in my view, became inappropriately easy. Two justifications for this change in policy were put forth at that time. For one, the 10% income tax surcharge was enacted in June, and a limit on Federal expenditures was proposed. The long-awaited fiscal action immediately led to improved expectations in the money and capital markets, and the Federal Reserve attempted to accommodate this improved climate, signaling a shift in policy by a reduction in the discount rate in August. (The Cleveland bank, I might add, reluctantly reduced its discount rate after a delay of several days.) The second and related factor influencing monetary policy in the last half of 1968 was a widely-shared forecast suggesting that the combination of monetary restraint and the income tax surcharge would produce a substantial slowdown in the U. S. economy in a few months. Of chief importance was an expected shrinkage in consumer spending, resulting from a reduced level of disposable income caused by the surtax. The majority in the Federal Reserve accepted this standard forecast and monetary policy was designed accordingly, with minor reservations expressed by some of us.

For the second half of 1968 as a whole, the rate of growth in both total bank reserves and nonborrowed reserves increased sharply, exceeding 8%. There was an explosive expansion in time deposits at commercial banks, reflecting bank intermediation, as short-term rates on Treasury bills fell below Regulation Q ceilings. As a result, the rate of growth in time deposits more than tripled from the first half to the second half of the year. But when we look at the money supply, the old problem of short-term erratic variation shows up again. In the second half of 1968, when monetary policy became easier, the rate of growth in the narrowly-defined money supply decreased sharply, dropping from 8% to about 3-1/2%. The chief reason for this was a reverse shift of funds from private hands to public accounts.

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Therefore, once again, I prefer to look at the credit proxy. The behavior of this measure between July and mid-December last year unfortunately reveals only too clearly that monetary policy was inappropriately easy. The credit proxy increased at an annual rate of 14% in this period, when measured both with and without Eurodollar borrowing. (Eurodollar borrowing leveled off in the second half of the year as interest rate differentials shifted and the pull on the Eurodollar market decreased.) This is not just my judgment after the fact, for the record will show that I dissented from the majority policy decision of the Federal Open Market Committee in October and again in November. More recently, there has been wider acknowledgment of the errors of our ways in the second half of 1968, expressed, for example, in the testimony of Chairman Martin before the Joint Economic Committee. In brief, the System was too much concerned with the possibility of "over-kill", to such an extent that other business and financial developments were overlooked. Prices were continuing to increase at a rapid rate, and consumer spending was supported at a very high level by increased borrowing and decreased saving.

Of course, a policy of monetary ease, however modest the ease was intended to be, could only go on so long against the emerging interplay of economic events. In December, the Open Market Committee finally voted for a more restrictive monetary policy, and the discount rate simultaneously was moved up again to 5-1/2%. Since then, there has been a contraction in the credit proxy and a decline in the rate of expansion of bank reserves. The rate of growth in the narrowly-defined money supply declined further from its already low rate of the preceding policy period, but I must add that this was not primarily caused by Federal Reserve action; it was chiefly the result of a further build-up in Treasury deposits in January and February.

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While the massive CD runoff has served the useful purpose of reducing bank liquidity, a certain amount of deposit and credit expansion is vital to insure sustainable economic growth. I confess that I am concerned about achieving sufficient bank credit growth in the balance of the year, particularly if the Treasury has any success at all in moving to a budget surplus in the second half. This means that once again the monetary policymakers are facing a difficult decision. We are worried about sufficient economic growth and the effect on unemployment, but at the same time we must cope with inflation. Price inflation in this country is not yet under control, and the recently-released plans for plant and equipment spending in 1969 do not suggest any relaxation in the business sector of the economy.

Earlier in the year, a credibility gap seemed to have developed between Federal Reserve intentions and the acceptance of these intentions by the market place, but recent developments in capital markets indicate that this gap now has been closed. We would all agree that a policy change toward restraint in the growth of money and credit was needed, but I would suggest (and I may again be in the minority on this) that the severity of the restraint that has developed in the past three months may have gone on long enough. My objective is to cool the economy, which means that I favor moderate credit restraint, not a crunch.

To sum up, then, there are those who believe that monetary policy will have to get tighter before we can loosen the screws, and there are those who believe that we have already gone far enough. I happen to be among the latter group; but of course I could be wrong. Hopefully, some light will be thrown on this difficult question by the discussion here tonight.

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