Economic Roundtable Luncheon
at the Bank
Tuesday, December 28, 1965

MONETARY POLICY AND CURRENT ECONOMIC TRENDS

I. INTRODUCTION

One cannot speak about monetary policy these days and avoid mention of recent System actions, the increases in Reserve Bank discount rates and the increases in Regulation Q time deposit rate maxima. Nor shall I try. Quite the opposite. I shall spend all of such time as has been given me on, first, the System's rationale for these actions and, second, what its critics have had to say about them.

II. THE CHANGE IN REGULATION Q

A. THE FACTS: 1) no increase in maximum savings deposit rate (generally represented by a passbook)

2) increases to 5½ % for all time deposit rate maxima (generally represented by a certificate of deposit)

B. WHY THIS PATTERN OF CHANGE?

The Board's feeling is that the savings deposit rate is of crucial importance in the competitive struggle between commercial banks and savings and loan associations. Yet, for some time -- and in part at the urging of Federal Reserve officials -- the Federal Home Loan Bank Board has been trying to hold savings and loan ~~a~~ share rates down. There was concern ~~Frankly, government officials have been afraid~~ that some savings and loan associations might over-step the line of prudence in their scramble for funds. In light of this concern, an increase in the commercial bank savings deposit maximum rate would have seemed strange. It might have put the FHLBB in an untenable position -- vis a vis the savings and loan industry, that is -- and struck some as a double-cross.

C. WHY THE INCREASES IN MAXIMUM RATES FOR NEGOTIABLE CD'S AND OTHER TIME DEPOSITS

In a sense it is true that the Board had to act. Market rates were edging uncomfortably close to the 4½ % ceiling that was in effect before the most recent changes and banks, particularly the large ones, had a big December maturity of CD's to roll over. There was considerable apprehension that they wouldn't be able to at the 4½ % rate.

D. WHY THE JUMP TO 5½ %?

In other words, why was Regulation Q -- insofar as it applies to time deposits -- put on a stand-by basis? First off, let me be clear that there was no thought that time deposit rates would go immediately, or even in the distant future, to the new 5½ % ceiling. If this is what the Board thought would happen, it couldn't have been thinking of itself as putting Regulation Q on a stand-by basis. Why, then, did it want to do this? Largely, one suspects, to get away from having to make periodic adjustments in rate ceilings. (Or in open market policy!) Having banks operate close to or at a rate ceiling is unsettling. Uncertainties develop, both for banks and for the markets generally.

Yet Regulation Q, even if immediately ineffective, still may have a purpose. There could come a time when, to prevent a competitive price war which served no useful purpose, the Board of Governors would want to make the Regulation Q ceilings effective again. Even the threat of this may have a beneficial effect.

E. ON THE MARKET FORCING THE FEDERAL RESERVE'S HAND

Previously I said that in a sense the Board of Governors had to increase the Regulation Q ceilings on time deposit rates. One cannot push this explanation too far, though, for the Federal Reserve has the ultimate say -- at least within broad limits -- about what open market interest rates shall be. This isn't something the System is fond of admitting, if only for political reasons. Still, it is true. And consequently it is also true that in a sense the Federal Reserve, by permitting or forcing an increase in open market interest rates through October and November, forced itself to increase the Regulation Q ceilings on time deposit rates.

Ultimately, therefore, the wisdom of the increase in the Regulation Q ceilings depends upon the wisdom of the prior increases in open market interest rates. This is the matter to which I now turn. But first a few words about the increases in discount rates.

III. THE INCREASES IN DISCOUNT RATES

A. MARKET RATES AND DISCOUNT RATES: THE RELATIONSHIP

Insofar as the recent increases in discount rates are thought of as technical adjustments, what I've just said about the Federal Reserve forcing its own hand applies again. Open market rates are powerfully affected by open market operations and when the System moves to greater monetary restraint by means of open market operations, it must -- in a manner of speaking, with its other hand -- increase discount rates to keep them in line with market rates.

there were six reasons —

① high degree of utilization of labor and plant.
② balance of payments
③ the rate of price increases
④ the rate of plant investment spending
⑤ the capability of the banking system to meet future demands.
⑥ Viet Nam -

B. THE INDEPENDENT EFFECT OF A DISCOUNT RATE INCREASE

But an increase in discount rates sometimes has its own independent effect on market rates -- as, clearly, it did this time around. And largely, one suspects, becuase of the effect on the expectations of money market participants. When discount rates are increased in advance of market rates, as they were this time around, market participants come to expect a new, higher level of market rates -- a new, higher level basis on the historical association, for boom periods, between discount rates and, say, Treasury bill rates.

C. AGAIN THEREFORE WHY THE CONCERTED MOVE TO HIGHER INTEREST RATES?

That the most recent increases in idscount rates would raise market rates should have been expected. So, again, we must ask why, with respect to Regulation Q ceilings, did the Federal Reserve force its own hand and why did it seek, through increases in Reserve Bank discount rates, to exert further upward pressure on ~~xx~~ market interest rates?

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1. NO BALANCE OF PAYMENTS CRISIS

Most emphatically, the System did not act becasue another crisis of ~~xx~~ confidence in the dollar was ~~in the offing~~ emerging. This looming threat may have prompted the discount rate~~s~~ increases o f mid-1963 and late 1964. But not this time. ~~This time the crisis was in sterling.~~ The Administration's balance of payments program, if no permanent solution to our payments problem, ~~xxxx~~ has nevertheless improved our position and made a crisis of ~~xxxx~~ confidence in terms of sharp focus an unlikely event.

2. A DOMESTIC BOOM

No, the reason for recent actions is to be found in the domestic economic situation and, more specifically, in a surprisingly bouyant U.S. economy.

- As late as August of this year many economists — including the dummies on my staff — were expecting that the second half of 1965 wouldn't be as good as the first half, which you'll recall was heavily influenced in an expansionary way by the late 1964 auto strike and by steel inventory buying. Yet GNP, in current prices, increased by $11.5 billion in the third quarter of this year — by more, that is, than in the second quarter ($9.5 billion). And the likelihood is that the fourth quarter — the one we're just now wrapping up — will see an even larger increase, something like $12.5 billion.
- Somewhere along the line, then, our economy began to accelerate again. It began to accelerate before many of us became aware that it had.

3. THE OUTLOOK FOR NEXT YEAR

And the outlook for next year has changed. A couple of months ago economists were talking of a $710 billion GNP (in current prices) for next year. They were saying that 1966 wouldn't be quite as good as 1965 had been. Now many economists are talking of a $720 billion GNP for 1966 and are' saying that 1966 will turn out slightly better than 1965

- Indeed, there is talk now of tax increases. Some economists are even saying that we could reach a $720 billion GNP in 1966 with a modest tax increase.

4. A <u>SLIGHTLY</u> GREATER THREAT OF INFLATION

You all know what has lately been happening to unemployment rates, so I won't bore you with the statisitcs. What you may not know is that there is evidence of a return in November to the rate of price increase experienced early in 1965. Before mid-year the wholesale price index for industrial commodities -- which, clearly, is <u>the</u> important index -- was increasing at a rate of about 2 % per year. From July through September, however, the rate of increase was more moderate -- about 1 % per year. But in November, as I've said, there was some acceleration. Again, this index is increasing at about a 2 % per year rate.

- Quite obviously, we aren't anything like in the grip of inflation. Nor will we likely be so caught in the foreseeable future. But a step-up in the rate of price advance has got to be expected if GNP increases from quarter to quarter by, say, \$13 - \$14 billion. And this was the outlook before the Federal Reserve acted.

5. A REASONABLE RESPONSE

Now, I submit that against the background I've sketched, System actions of early December appear quite appropriate. Viewed in the light of the consensus forecast for 1966, these actions appear quite appropriate.

D. THE ISSUE OF THE TIMING OF FEDERAL RESERVE ACTIONS

1. THE ARGUMENT THAT FEDERAL RESERVE ACTIONS WERE POORLY TIMED

It has been argued that the Federal Reserve should have waited with its increases in discount rates at least until mid-January -- until after the budget for fiscal 1967 had been announced. The points made by those who have so insisted are, first, that a month or two delay wouldn't have mattered greatly and, second, that only when monetary and fiscal policies are decided in concert can proper design of over-all economic policy be achieved.

- In rebuttal of these points I can only say that in general they may be well taken but that in this instance they are without great force.

2. WILL THE BUDGET ANNOUNCEMENT CHANGE ANYTHING?

It can be granted that a couple of month's delay might not have been crucial. But it must also be granted, I believe, that the chance of a fiscal 1967 budget that would have fundamentally altered the outlook for 1966 was and is extremely small. Thus, one can well ask what risks the Federal Reserve ran by acting, as its critics say, "prematurely?" The answer, I think, is "precious few."

3. COORDINATION - WOULDN'T IT HAVE INVOLVED RATE INCREASES ANYWAY?

It can also be suggested that a properly coordinated policywould in any event have involved increases in interest rates. It can be suggested, in other words, that come next January the Administration would have decided on an increase in interest rates as a substitute, in whole or in part, for a tax increase. The point, it seems to me, is that what we want to do now is cut back, if slightly, on business investment spending rather than consumption, whether private or public. We have a very considerable investment boom on our hands at the moment, a boom which threatens the stability of business investment goods prices and which threatens to give us too rapid a build-up in productive capacity and, sometime in the future, too rapid a slow-down in investment spending. What I'm saying of course is that sustainable economic growth demands, not a tax increase that effects consumption spending primarily, but an increase in market interest rates which has its direct effect on business investment spending.

4. IN THE BACKGROUND IS STILL THE BALANCE OF PAYMENTS PROBLEM

Also, it remains true -- so long as our balance of payments position continues unsatisfactory -- that an change in the "mix" of our monetary and fiscal policies should be in the direction of higher interest rates. So for yet another reason it appeansthat the Federal Reserve, by acting in early December rather than mid-January, was only anticipating what would then have been a properly coordinated move.

5. THE PROBLEM OF BANK LENDING RATES

There is finally a last reason why waiting until mid-January probably wouldn't have made much difference. The Federal Reserve has many concerns -- and not least among them is the proper allocation of credit. With bank lending rates all out of line, though, as they clearly were until recently, a proper flow isn't achieved. But to get lending rates -- and particularly the prime rate -- into line, it was necesarry, given the political situation, to increase discount rates.

- Nor does an increase in discount rates necessarily deny our over-all employment objectives. It is always possible to compensate for discount rate increases by being a little easier with the budget. This is what we ~~xxx~~ mean by coordination of fiscal and monetary policies.

E. THE ROLES OF THE PRESIDENT AND THE FEDERAL RESERVE

In conclusion, let me say only that those who argue that the System should have waited with its changes in rates may in ~~xx~~ effect be saying that only the President, as the elected representative of all the people, can decide how to compromise our twin economic objectives -- full-employment and price stability. They may in effect be saying that only the President can decide how ~~xxxx~~ close we should try to come to our full-employment objective -- or, in other words, how much inflation we should accept in the interest of high-level employment. This is a weighty argument. About this we should be clear. But we should also be clear that <u>in law</u> the President is not presently the only arbiter of our economic objectives. At the moment the Federal Reserve has, under law, a certain indpendence -- an independence which,,if it is to be true to its charge, it must exercise when it sees the need.