FEDERAL RESERVE POLICY: IN RETROSPECT AND PROSPECT

Remarks by

Hugh D. Galusha, Jr., President
Federal Reserve Bank of Minneapolis

Wisconsin Bankers Association
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It has become the custom for an invited speaker, in opening his remarks, to thank his hosts for the opportunity to appear before them. But in thanking your president, Mr. Lewis, and you, members of Group One, Wisconsin Bankers Association, I am not just being polite. I do sincerely appreciate this chance to appear before you this afternoon and talk about monetary policy. Such success as the Federal Reserve System has enjoyed through the years can be traced--and in no small part--to the support commercial bankers have given its policies. But whatever their brands of cigarettes, commercial bankers are thinking men. They are either thinking men or they are unsuccessful bankers. And thinking men give their support only when they understand. So I come before you today in the fond hope that I will promote understanding of what the Federal Reserve has been up to and, in so doing, gain for the System an increased measure of support from you.

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I want to talk first about that remarkable year, 1966--about what, in my personal opinion, we should have learned from the experience of those 12 crowded months. Then I shall turn to 1967, to what the Federal Reserve has lately been trying to do and likely will as the rest of the year unfolds.

To begin, I must go back, though, to mid-1965, not the start of 1966. Roughly speaking, this is when the pronounced escalation in Vietnam began and when, in hindsight, Federal Reserve Banks should perhaps have increased their discount rates. But, of course, policy-makers cannot act in the wisdom hindsight affords. And through the summer and early fall of 1965, few knew how rapidly Federal defense expenditures were increasing. If the Pentagon knew, it was not saying. Few suspected then that the balanced economic recovery which began in 1961 was at long last becoming unbalanced. Indeed, when Federal Reserve Banks did increase their discount rates--several months later, in December 1965--they and the Board of Governors were roundly criticized for tightening credit prematurely.

Fortunately for all of us, the Federal Reserve's judgment was confirmed by subsequent events. As of December 1965, additional monetary restraint was appropriate. It can be argued that if the System had not moved dramatically then, we would have got a tax rate increase early in 1966. Moreover, this argument has a certain plausibility, for as we all know, fiscal and monetary restraint can be substituted one for the other. But there was no indication at the time that a tax rate increase would be forthcoming. And, besides, monetary policy's great advantage is that today's actions can easily be reversed tomorrow. Had a tax rate increase been effected in early 1965, the actions of December could have been modified. And willingly would have been, I suspect. I say this looking to what has lately been the course of monetary policy.

There is another reason why the Federal Reserve had to act in December 1965. As you will painfully recall, banks were back then in an almost untenable position, with deposit rates relatively high and loan rates, which they had tried unsuccessfully to increase, relatively low. But too low a prime rate has its broader economic implications as well. And these the System could not ignore either. The fact is that during late 1965 banks were making too many loans that should have been contracted for in the capital markets. Why? Because, as I have indicated, the prime rate was too low relatively. When Reserve Banks increased their discount rates, though, banks found it possible to increase their prime rate.

I seem to have gotten stuck in 1965, but before pushing on to 1966 let me recall the other year-end policy action. In December 1965, the Board increased Regulation Q ceilings--to where, as was thought, they would be out of touch with market rates for a good long time. Critics have suggested that the Board under-estimated the "magnet-like" effect ceiling rates have on market rates and that it would have been better advised to increase ceilings less than they were. For myself, I am not sure. What I would like to stress here, though, is the Board's reason for increasing ceilings. They did so to give commercial banks the necessary freedom to compete for deposits and thereby to insure a proper distribution of the nation's credit resources.

I say this, not to curry favor, but because it is in my opinion what the System believes--that in setting monetary policy, it should be determining only the broad framework within which freely made private decisions allocate the nation's credit. It might appear from what was done in 1966 that the Federal Reserve does not believe this. But one can interpret what was done in 1966 another way--as revealing how pressed the System was, so pressed that it had to act contrary to its basic philosophy.

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In referring to what happened in 1966, I had in mind, first, the issuance of the September 1 letter on discount policy and, second, the holding of the $5\frac{1}{2}$ per cent CD rate ceiling through late summer and early fall. You are well aware, I am sure, of what the September 1 letter said, so let me only add that in issuing it the System accomplished its avowed purpose, which was to moderate the growth of bank loans to business. It accomplished its purpose, though, not because bankers came to Reserve Bank discount windows and therefore had to follow our advice. Rather, it accomplished its purpose because bankers, understandably desirous of keeping control of their own affairs, did what was necessary to stay out of debt to the Reserve Banks. I can say that I am pleased--relieved would be a better word--that things worked out this way.

You are also well aware, I am sure, that in holding to a 5½ per cent CD rate ceiling during 1966, the System put the larger banks under considerable pressure. It forced a run-off of CDs and, in yet another way, a lessening in the availability of bank credit. Nor can there be any doubt, it seems to me, that the sharp increase in credit restraint effected by the System during 1966, and especially after mid-year, was necessary. But here the issue is whether we were justified in using the methods we did to get this added restraint.

In my view, we were. I see the System as having had little choice during mid-1966. Inflationary pressures were still strong. And yet, if we had proceeded in the classical way, by being even stingier than we were with bank reserves and letting interest rates find their own levels, these rates would have gone considerably higher than in fact they did. Rates were very high during 1966. But had we taken the classical way, which as a general matter we all prefer, they would have been much higher.

And to what end? The housing industry would have suffered even more than it did. Possibly monetary policy would have been, on this count, even more discredited in some quarters than it was. And in this connection, we would do well to remember that there will be other wars to be fought.

Then, too, there was the situation of savings and loan associations to be considered. And, beyond, whether the System might impair confidence in the economy's financial structure. There are those--mostly bankers, I am sorry to say--who have insisted that it is no part of the Federal Reserve's business to worry about savings and loan associations. I would insist, however, that the System's ultimate responsibility is to maintain public confidence in the financial structure and that if on occasion this requires worrying about savings and loan associations, then so be it. I would insist further that bankers who do not grant this are being short-sighted in the extreme.

Let me be quite clear on one thing. I certainly am not suggesting that, as a group, savings and loan associations are poorly run and not deserving of the public's confidence, or that, as a group, they were in danger of collapsing in mid-1966. This is simply not true. I am suggesting, though, that because of a few the situation was fraught with danger and that the System had to concern itself with this worrisome few.

That the System had to eschew the classical way and resort to selective monetary controls during 1966 is in many ways unfortunate and, for myself, I hope it will not have to again. It had to, I believe, because it was asked to shoulder too great a responsibility for restraining inflationary pressures. Had there been greater fiscal restraint, the System could have made its modest contribution in the traditional way and without disrupting financial relationships of long standing. I have, then, come away from 1966 convinced, first, that the Federal Reserve can, in a pinch, carry most of the stabilization burden itself, second, that in a pinch it will, and third, that not too much should be asked of it. The results, when we ask too much of the Federal Reserve, are strains and stresses the economy would be better off without. Legitimately concerned with these wrenching, disproportionate effects on the different sectors of the economy, Congress moved discretely last September, when it passed an interest ceiling bill. There is, however, no assurance that this will be the case next time around. Legislative remedies may cure the patient--but they sometimes shorten his life.

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If I have spent a good deal of time talking about 1966, it is only in part because I believe we have just come through a time pregnant with meaning for the future. It is also in part because I dread talking about the unknown, 1967, which, though, is what I foolishly promised I would do at the outset of these remarks. The truth is that I know no more about what is left of 1967 than you do. I sometimes get the uncomfortable feeling that, as a Federal Reserve official, I am endowed by my friends (and enemies) with a great gift of prophecy and that my casual remarks about coming economic events are given great weight. If you knew me as I do, you would appreciate why this makes me acutely nervous.

For some little while now, as you know, the Federal Reserve has been working toward greater monetary ease. And for the obvious reason. Inflationary pressures have become less strong. Of course, the recent marked decline in interest rates is not entirely the System's doing. The private sector's appraisal of 1967 has changed. Most importantly, the President's call for a tax rate increase triggered expectations of greater monetary ease and, in consequence, interest rates declined. Still, the System has done its part. And happily, I would add. Whatever our critics may say, we did not enjoy 1966. This is most clearly revealed by the promptness with which the System moved to a policy of greater monetary ease.

But it would be quite wrong to interpret the recent decline of interest rates and the increase in credit availability as signaling a recession. In the Federal Reserve anyway, the dominant expectation would seem to be that the end of 1967 will find the economy growing more rapidly again. This is what Chairman Martin told the Joint Economic Committee of Congress in his appearance of a couple of weeks ago. And apparently the Administration is also expecting the present slow-down to be only temporary. Otherwise the President would hardly have proposed his 6 per cent surtax.

With an economic outlook more optimistic than pessimistic, it is perhaps not to be expected that interest rates will decline a whole lot further. As I have emphasized, we have already had a dramatic decline in rates. But beyond this, what can one say. The difficulty, apparent enough, is that what the Federal Reserve does in coming months must depend largely on what the Congress does and what monetary authorities in other countries do. In matters of taxation, the President proposes, but the Congress disposes. And since the President has made his proposal, it is up to the Congress how much freedom for maneuver the System is going to have.

In some lesser measure, it is also up to the monetary authorities in other countries to decide how much freedom the System shall have. Our government could go further than it has in directly controlling international flows of funds, but our present network of controls allows for the free movement of short-term funds. In consequence, the differential between monetary conditions here and abroad still influences considerably our balance of payments position. Witness what happened in 1966, when a massive inflow of Euro-dollars gave us a slight official settlements surplus.

Actually, the dollar has never enjoyed greater confidence than it does today. But to maintain confidence, we have got to be watchful of our international payments position. It could dissolve in a return to larger deficits.

For good or bad, the Federal Reserve is therefore limited by world monetary conditions. We have lately witnessed a marvelous instance in monetary cooperation. In concert, Germany, the U.K. and the U.S. have worked toward lower interest rates. But whether domestic conditions in the several countries will remain such as to allow the effort to continue is not easily foretold.

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I am aware of having been of little help on what the future holds. For this, I have already offered my apologies. I do hope, though, that I have made some small contribution to your understanding of why the System has behaved as it has. This is what I most wanted to do, for as I indicated when I began these remarks, the Federal Reserve does need your thoughtful support. And I might add, your thoughtful criticisms. Both, though, require understanding of what the System has been trying to do and why.