Remarks By

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A REVIEW OF RECENT MONETARY POLICY

I do not intend to start this talk with the conventional expression of gratitude to the chairman for the opportunity to appear on today's program, for this would imply an element of volition on both our parts that would be quite inaccurate. Explaining recent monetary policy, which obviously requires an explanation of the economic environment of the same period is not all that easy. As Henry Wallach said in his column in the current NEWSWEEK, we not only are unable to tell where we are going--we can't even tell where we've been.

John Kareken and I were visiting last night about this phenomenon and he reminded me of the scene in The Skin of Our Teeth, in which the greater problems of retrospection are discussed by the soothsayer. Partly because it's germane to this talk, and partly because it is important to surprise college professors occasionally by a demonstration that they are listened to, I sent out for a copy of the play this morning--

> "But who can tell your past? Nobody---What did it mean? What was it trying to say to you?---Think!---I can't tell the past and neither can you. If anybody tries to tell you the past, take my word for it, they're charlatans."

Where have we been and where are we going? Speculation on these subjects is useful, if for no other reason that the enforced and disciplined mental housecleaning process involved.

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To begin, I must go back to mid-1965. 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 the Federal Reserve, its 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 gotten 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. 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. In saying this, I have in mind how quickly the System reversed itself in late 1966, as soon as it became apparent that the economy was slowing down.

There is another reason why the Federal Reserve had to act in December 1965. Back then, banks were in a very difficult 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. In any event, what I would like to stress here is the Board's reason for increasing ceilings. It 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.

In my personal opinion, this is 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 holding of the 5½ per cent CD rate ceiling through late summer and early fall and, second, the issuance of the September 1st letters on discount policy. You are well aware, I am sure, that in holding to a 5½ per cent rate ceiling on large denomination certificates of deposit, or CD's, the System put the larger member banks under considerable pressure. It forced a run-off of CD's and thereby a sharp change in the supply of bank credit.

But back in the summer of 1966 the System did not feel it could content itself with checking the growth of bank credit. It felt it had to go further and check the growth of business loans, which rightly or wrongly were thought of as having a special significance in an inflationary setting.

To this end, the Reserve Banks issued their famous September 1st letters on discount policy. You are perhaps aware of what these letters said. They acknowledged that with an increasingly effective CD rate ceiling, individual banks might well experience significant reserve losses. And they promised that traditional discount window financing would be available, but suggested, and this is the rub, that banks interested in Reserve Bank loans should be prepared to adjust to lower deposit levels by reducing business loans.

This banks did, but before, not after, coming to their Reserve Bank discount windows. The September 1st letters turned out then to be an exercise in moral suasion; the Reserve Banks never had to make actual loan decisions for member banks. For myself, I can only say I am pleased--relieved would be a better word--that things worked out this way.

Nor can there by 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.

I 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 I personally 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, and second, 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 the wrenching, disproportionate effects of monetary policy on the different sectors of the economy, Congress acted last September. It passed an interest ceiling bill. Now, therefore, not only are commercial bank deposit rates subject to administrative ceilings, which though are flexible; the rates paid by mutual savings banks and savings and loan associations are as well. In passing its bill, Congress allegedly authorized only temporary administrative control of rates paid by savings banks and savings and loan associations. One wonders, however, if the authorization given the FDIC and the Federal Home Loan Bank Board will ever be taken back and, further, just what price we will end up paying for having asked too much of monetary policy.

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If I have spent a long time talking about 1966, it is because I believe we have just come through a time pregnant with meaning for the future. And not the far-distant future. I have in mind the immediate future. Before too many months have gone by, we may again face the choice we faced in early 1966--whether to increase tax rates or rely instead on increased monetary restraint.

As you know, it was early last fall that the Federal Reserve began working toward greater monetary ease. And for the obvious reason. Inflationary pressures stemming from excess demand had eased appreciably from what they had been in early 1966. Of course, the marked decline in interest rates that persisted until only very recently was not entirely the System's doing. Last fall the private economy's assessment of 1967 also changed. Most importantly, the President's call for a surtax triggered expectations of greater monetary ease and, in consequence, interest rates declined. Still, the System did its part. And happily, I would add. Whatever our Populist critics may say, we did not enjoy 1966. This is most clearly revealed by the promptness with which policy was changed.

That the System has gone as far as it has in reversing the monetary policy of 1966 is to be explained, at least in part, by the lessening of demand for goods and services in Europe and, in particular, Britain and Germany. Against a background of threatening recession, not only in the U.S. but Europe as well, the major countries of the western world have been able to work a concerted reduction in interest rates. Without near-matching reductions in other countries, it is doubtful that the Federal Reserve could have allowed U.S. interest rates to fall as much as they have. It is heartening, this most recent instance of international monetary cooperation. Would that we could always count on circumstances being right for international cooperation.

We may now have arrived, however, at a point where the need for further reductions in interest rates cannot be taken for granted. The problem may no longer be how the Federal Reserve can stimulate domestic demand for goods and services without at the same time worsening our U.S. balance of payments position. It has all along been the contention of the administration--and, I might add, the Federal Reserve--that there would be no recession. And lately the available signs have been pointing to a rigorous expansion being underway again by year's end. It could be that come late 1967 or early 1968 the problem will again be an excessive demand for goods and services.

The experience of 1966 should leave no doubt that there is a remedy for excess demand immediately at hand. The country could again rely entirely on the Federal Reserve. But if it does, will the effects be any different than in 1966?

We are now nearing the second anniversary of the first acknowledgment I heard privately from a major national figure that we were engaged in a war. The slide has been gradual enough to coat over the strains on our economy a determination to provide both guns and butter have produced--and are continuing to produce. All resource allocation processes are affected by this drive. I suspect that whatever advances in the state of the art of linkage analysis have taken place have only partial relevance in this milieu--

and may I parenthetically add that Webster indicates the term "milieu" is a term of two definitions--the one less known applies to a betting system in roulette.

I would like to come squarely down on the side of a tax increase to be effective January 1, 1968. If the economy does not leave 1967 in a mood of exuberance which current trends and the escalation of the war seem to assure, it could be cancelled. There is at least as much justification for stop-go fiscal policy as for monetary policy.

If monetary policy has to assume the major obligation to stop such a break-out, let us remember it would be starting from relatively higher rates, especially on the long side. The people on main street, and particularly in agriculture, are not all that adjusted to the present structure.

As I indicated previously, the rates paid by all the various kinds of financial intermediaries are now subject to administrative control. Since only commercial bank rates were so subject until September 1966, it could be that next time around the housing industry would not be hurt quite as badly by exclusive reliance on monetary policy as it was in 1966. Still, it almost certainly would fare very badly indeed. And while next time around there might not be the threat to savings and loan associations there was in 1966, the spectre of disintermediation could walk again.

But, again, for myself I prefer market allocation of loanable funds. The point of 1966 would seem to be that the alternative to fiscal restraint can be reliance on direct monetary controls. And, as I have said, this point may become of immediate relevance before too many months have passed if fiscal action is not taken.