Remarks by

HUGH D. GALUSHA, JR.

President

Federal Reserve Bank of Minneapolis

at the

Tenth Annual Controllers Conference

National Sand and Gravel Association
National Ready Mixed Concrete Association

Saint Paul Hilton

Saint Paul, Minnesota

July 23, 1968

As some of you may know, I came to the Federal Reserve System from a lifetime in tax practice only a relatively short time ago--in March 1965, to be exact. This is only a little more than three years ago, and yet I have moments when it seems as though I have been president of the Federal Reserve Bank of Minneapolis for an eternity. I have witnessed and helped contend with my share of crises, both domestic and international, as I am sure you will agree. But I also have moments when I think of myself as having been extraordinarily lucky. From the beginning, I have had an exciting time, both as president of the Minneapolis Bank and as a member of the Federal Open Market Committee, which in large measure shapes monetary policy. I have had a rare opportunity to learn. And at the risk of seeming immodest, I will say that I have learned two things. What exactly? The first thing is that the Internal Revenue code at its incomprehensible worst is a child's primer compared with some of the pronouncements by monetary economists on the events of the last three years. For another thing, too much should not be expected of the Federal Reserve System. It cannot be counted on single-handedly to restrain inflationary pressures, or to forestall crises of confidence in the dollar.

This last may strike you as a strange lesson for a Federal Reserve official to have learned--or, having learned it, to confess publicly that he has. It is extremely important, however, that we confer upon our public institutions--and the Federal Reserve System is that, a public institution--responsibilities no heavier than they can reasonably shoulder. So, to begin, let me explain why I believe that the System cannot be relied upon to, for example, prevent inflation by itself, or why I believe, as I do, that it must operate against the background of an appropriate fiscal policy.

As I have learned--to my sorrow, I might add--economists disagree among themselves on many things. You might say they disagree on as many things as tax attorneys, except that they express their disagreements in even more complicated language. They disagree on how effective an increase in interest rates, or the cost of borrowing, is in restraining total demand for goods and services. Some say that a change in the cost of borrowing has an effect, that when this cost increases some businessmen postpone purchases of plant and equipment, and possibly inventories as well; and that some prospective house-buyers postpone their purchases. There are others, though, who stress the availability of loanable funds. These economists say that what restrains demand for goods and services is the simple unavailability of funds. A businessman or prospective house-buyer may be quite willing to pay whatever it costs for funds, but if he cannot get the funds, possibly because no bank has them to lend at any reasonable price, he will not be able to purchase that new plant or new house.

For myself, I am inclined to side with those who stress the availability of loanable funds, or credit rationing, although I would certainly agree that any increase in borrowing costs, if appreciable, must dissuade at least a few would-be spenders from carrying out previously made plans. The point, however, is this: whether monetary restraint works through an increase in borrowing costs or an increase in credit rationing, it will be reflected in increases in rates on marketable securities, both short-term and long. It must involve an increase in rates on Treasury bills and commercial bills, and on rates on Treasury bonds and the bonds of corporations and state and local governmental units. And if total demand for the nation's output is greatly in excess of the nation's ability to produce, as lately it has been, then monetary restraint must involve sharp increases in market interest rates. Curbing inflationary pressures by means of monetary policy involves increasing interest rates--in proportion, as it were, to the strength of the pressures.

Which brings me to the problem. Increases in market interest rates, if sufficiently rapid and sharp, can threaten the stability of the financial system, and in addition severely alter the pattern of economic activity in the nation. Let me explain. One of the remarkable advantages the U.S. enjoys is that it has a broad network of thrift institutions which channel private savings into the hands of those who want to invest, whether in new houses or new plants. These institutions offer savers highly liquid financial assets; and at the same time they offer borrowers long-term loans. To oversimplify a little, these institutions borrow at short-term and lend at long-term. Which is fine, except that when market interest rates increase, borrowing costs of these institutions increase more than do portfolio earnings. This is simply because these institutions, if they are to maintain their share and deposit accounts, must pay something like what share and deposit owners can earn on alternate investments. But these institutions cannot increase their portfolio income until their previously-made loans mature. Of course, when market interest rates decrease, borrowing costs decrease more than do portfolio earnings. And over a long enough period borrowing costs and portfolio earnings will, as it were, balance out. But this is small consolation to the thrift institution which during a period of rapidly increasing interest rates has become insolvent--or, in the vernacular, gone broke.

Over recent years we have accumulated a good bit of evidence, both casual and statistical, that savers are sensitive to interest rate differentials, and that some savers do shift their funds to take advantage of better opportunities. We have accumulated evidence that savers, small and large, will switch from deposit or share accounts into, for example, Treasury securities to gain an interest rate advantage, or from Treasury securities into deposit or share accounts if this is what the going interest rate spread dictates. It is not clear that savers are quick to switch between debt and equities, depending on what the outlook is, but it is enough that some will not hesitate to switch between, on the one hand, deposit and share accounts and, on the other hand, market securities. It is this willingness to shift which gives rise to the dilemma of thrift institutions--and, I might add, the Federal Reserve.

If thrift institutions do not increase the rates they pay deposit and share owners, they will lose funds, and when they have exhausted their own credit lines will be forced to liquidate assets. Even if possible, liquidation can involve considerable capital losses, and so threaten solvency. And, of course, liquidating mortgage loans is not always possible. But if rates paid deposit and share holders are increased to levels high enough to keep savers hitched, the margin starts to disappear; and the increase in costs has to be paid not out of current earnings but out of accumulated surplus. And quite obviously payments out of accumulated surplus cannot go on forever.

I have stated the dilemma posed for thrift institutions, and thereby for the monetary authority, the Federal Reserve System, starkly--too starkly perhaps. I did not mean to suggest that any increase in market interest rates, however slight, threatens the stability of the financial system. I meant to suggest only that a sudden increase in rates, to sharply higher levels, can do so. But sudden, sharp increases are what we should have in mind if we are thinking about the Federal Reserve, by itself trying to maintain price stability--or trying to offset, in a full-employment environment, a sharp increase in the federal government's deficit.

Nor did I have in mind that poor management of thrift institutions is ultimately the explanation for the Federal Reserve's inability to do all that is necessary to prevent inflation. No doubt some thrift institutions have been poorly managed. No doubt some have taken extreme risks to maintain impressive rates of growth. Poorly managed thrift institutions have, however, been the exception. But even among well-managed institutions, a sharp, sudden increase in market interest rates can pose an awkward dilemma. And as I have indicated, the Federal Reserve faces a dilemma too. A sharp, sudden increase in market interest rates may be necessary to restrain inflationary pressures. But an increase in rates, if sharp and sudden enough, can threaten the solvency of the financial sector.

Lest I be thought of as conjuring up unreal dilemmas, let me recall for you the experience of 1966. Over the first half of 1966, market interest rates were increased considerably, although less than was required to prevent a general increase in prices. Why less than was required? Because many thrift institutions lost considerable sums, and some were at the danger point. Losing funds as they were, they were hardly in a position to sustain the flow of mortgage loans, and as a result the construction industry nearly ground to a halt. My mother used to caution me about reminding people of unpleasant personal history by saying one never speaks of a halter in the house of one who's been hanged. The plight of the construction industry in 1966 is such a halter to this audience, I suspect. Let me say only that the collapse of the construction industry in 1966 shows the inequity of relying too much on monetary restraint, or alternatively too little on fiscal restraint. It is pretty much inevitable that the construction industry is going to suffer more, much more, under monetary restraint than, say, the shoe industry or even the automobile industry.

This is of course because of the close link between the construction industry and all institutional lenders, but especially the thrift institutions. It is axiomatic that if the principal suppliers of funds to an industry are in trouble so is the industry. And in trouble these fund suppliers were. As money market rates rose for bank CD's and for government and corporate bonds, savers took their money from S & L's to the banks or to the market and by-passed the intermediate thrift institutions. This phenomenon was glorified with the title of "disintermediation," and the suffering of the patient was in direct proportion to the incomprehensibility of the name of the disease.

That there has not been anything like as much disintermediation so far in 1968 as there was in 1966, is partly because the Congress, spurred by developments of early 1966, passed a bill in September of that year which empowered regulatory agencies to set limits on rates paid by thrift institutions, and required that the Federal Reserve, the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board jointly determine what appropriate rate ceilings might be. The aim was to limit rate competition between commercial banks and thrift institutions at least. It was felt that in 1966 many share and deposit owners switched not only to market securities but to commercial bank deposits, and that this switch, made possible by an increase in the rates banks could pay for time money in December 1965, had itensified the problem of the construction industry.

Of late, then, thrift institutions have not had to contend with as much competition from commercial banks as they had to in 1966. As an aside, let me add here that commercial banks are better able to cope with sharp increases in market interest rates than are thrift institutions. And for the obvious reasons. Their loans are on average of shorter maturity. Also, their borrowing costs do not increase as much. They do not pay interest--directly at least--on demand deposits.

But when Congress passed the Interest Control Act, it did not solve the Federal Reserve's problem. If it insulated thrift institutions from commercial bank rate competition, it did not insulate either the thrift institutions or commercial banks from market rate competition. For banks too, however better able to compete with the bond market than the thrift institutions, must inevitably lose deposits to the market place when their rates fall behind. All along there has been a danger that savers would shift to market securities, as to some small extent they have. To date, there has not been a massive shift, but in good part because the Federal Reserve has not forced market interest rates way up above the maximum rates which can be paid by thrift institutions and commercial banks. It has been careful not to, even though inflationary pressures have continued strong.

I have outlined why, in my opinion, the country cannot rely on the Federal Reserve to keep the price level stable, or to prevent inflation, and why in the future it must rely more than in recent years it has on fiscal policy. But please understand me. I am not saying that the Federal Reserve cannot be relied upon at all. Indeed not. As the recent past clearly shows, it can help restrain inflationary pressures, and deflationary pressures too. There is a world of difference, however, between asking the Federal Reserve to help in the task of maintaining economic stability and asking it to shoulder the whole task by itself.

Let me also add here by way of qualification that time and change could make one unlearn this lesson I have learned. By changing lending and borrowing practices, thrift institutions might to some extent insulate themselves from sharp, sudden increases in interest rates. There is the possibility certainly that they were caught, as it were, off guard in 1966, and they do seem even since then to have changed their practices somewhat. One can be hopeful, then, that in the wake of the experience of 1966 and to a lesser extent 1968 the thrift institutions will change somewhat, that they will shorten the average maturity of their asset portfolios, maintain stronger liquidity positions, and diversify somewhat their liabilities. To the extent that they do, the monetary authority will gain freedom of maneuver.

But only with a national fiscal policy geared to the necessities of the economy can we avoid the lurching, wrenching impact of excessive reliance on monetary policy. Not the least of the benefits of the tax bill just passed has been the easing of the money markets--not much to be sure on the long end, but the 20 or so basis points off the short government market is an encouraging sign.

It might be thought that Federal Reserve speakers and writers of market letters will be at a loss for subjects now that Congress has finally reacted. However desirable you or I might regard this, there is no hope for us. During these last three years, central bankers of the free world have been forced into the realization that no major industrial nation of the west can pursue its own monetary and fiscal ends oblivious of the impact they may have on others; or, conversely, in ignorance of the impact monetary and economic policies of other countries will have on it. Out of this realization has come patterns of cooperation that made it possible for the international monetary system to survive--so far--British crises, devaluation of the pound, disintegration of the London gold pool, the current French crisis, and of course our own intractable balance of payments deficit.

I have spoken of the threat posed by sharp, sudden increases in interest rates. I would not want to leave you with the impression that, out of fear, the Federal Reserve is henceforth going to work toward maintaining roughly constant interest rates. The truth is it cannot, for over the postwar period the U.S. has become the dominant international lender and banker. To put the point differently, the U.S. balance of payments and U.S. official reserves of gold and foreign exchange are importantly affected by the spread between U.S. interest rates and rates in the rest of the world. And what this means is that, to some extent anyway, U.S. rates have to be changed when rates in other important countries are changed. This would not be so bad were it not for the inclination of some governments, particularly in Europe, to rely greatly on monetary restraint, or for the inclination of some governments to increase interest rates to check inflationary pressures.

Looking ahead, then, you should not expect even roughly constant interest rates in the U.S. U.S. Monetary policy will have to be changed as monetary policies in other countries are changed. And to repeat what I said before, monetary policy has an important role to play in promoting economic stability. But to repeat my major point, which is a point made by the record of the past few years, it is no good hoping that monetary policy can substitute for an appropriate fiscal policy. Which is why the Federal Reserve has all along supported the President's call for a surcharge and why in the future it will continue to urge an appropriate fiscal policy.

For in the delicate balancing of domestic and international economic pressures, the job of the Federal Reserve will be made easier, and more importantly, less likely disruptive of highly vulnerable industries like yours, if major shifts in the direction of the domestic U.S. economy are accomplished by tax and spending changes of our government--that is to say fiscal policy. But one thing has been made abundantly clear--we cannot expect quick responses from fiscal policy. This means monetary policy will continue to attempt the dampening of domestic and international events on our money markets; and given the magnitude and frequency of these events, there is little reason to expect stability of either rates or availability of funds.