MONETARY POLICY IN PHASE II

Remarks

by

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I'm delighted to have this opportunity to come back to my former stomping ground in New York to share with you some thoughts about monetary policy in Phase II. Having said that I'm delighted, I'm not at all sure that I should be, since my immediate thought when this particular subject was suggested was that I was being invited to climb out on a very long limb and handed a saw. As in any such situation, it may end up that you feel cheated by not having been presented with a clearly charted path to guide you through the months ahead, while I nevertheless go away feeling somewhat exposed.

It's only natural that people should want to know about the future, and that financial people should want to know about future interest rates. Central bankers are usually chary about trying to satisfy this curiosity, quite rightly in my opinion, because they can hardly be called disinterested parties in the game. But perhaps there are some useful things that can be said, because we are all operating in uncharted seas at the moment, and need to be as clear as we can be about where we want to end up -- and how we might have the best chance of getting there.

Certainly there can be little quarrel with the goals that the President set for us in his August 15 statement outlining his New Economic Policy: a quick end to inflation and a return to full employment. Indeed, they are the same goals that the Administration and the Federal Reserve had been seeking before the word 'Freeze' entered our current economic vocabulary. But before the freeze, progress toward these goals was discouragingly slow. The whole point of the New Economic Policy was to speed up the process, and the strategy seems to me to be a valid one.

But since the New Economic Policy is a unique experiment for the United States, it raises a number of questions about the role of traditional economic policy tools, including monetary policy, in the new setting. One question, of course, is how best monetary policy can further the attainment of the desired goals within the framework and changed expectations associated with the New Economic Policy. A related, and rather prickly, question is the extent to which a flexible monetary policy is consistent with the New Economic Policy, with its reliance on administrative restraints on prices and wages.

Interest rates are prices, after all -- prices for the use of credit. And if other prices are to be subject to guidelines, it's understandable that some people wonder why interest rates shouldn't likewise be controlled. One can hardly deny that when interest rates change, costs do too, just as when wage rates rise -- although it is important to recognize that interest costs are normally small relative to the cost of labor or other inputs. Nevertheless, in principle the effect is the same. Or is it?

For years, people have puzzled about the nature of interest rates. Even now, there is no clear agreement on how they should be viewed in different contexts, but it is pretty clear that thinking of them as prices that are just like other prices is more often misleading than it is helpful. Perhaps the closest analogy is with the prices of commodities that are freely traded in commodity markets. The essence of this analogy, of course, is that we are talking about commodities whose prices are competitively determined -- and perhaps at least as important, whose prices fall as well as rise. That characteristic alone distinguishes interest rates from the prices of most other goods and services in the economy, and in itself argues for less of a premium being placed on seeing that they don't rise in the first place.

But the implications of the analogy go much further. If we are talking about a competitively determined price for a homogeneous "commodity," for example, a particular kind of loan, then we can be pretty certain that any effort to clamp a lid on the price below the level dictated by market forces will lead to scarcities, or diversions into other uncontrolled channels, that can only be overcome by rationing or other administrative controls.

Now those who argue for restraints on interest rates frequently allege that interest rates are not determined through free competition, but are set by the big banks or other financial institutions. In certain instances, the charge has some validity -- there are administered rates, and in those cases, the argument for official action to speed the adjustment of such rates has greater force, as recognized by the Committee on Interest and Dividends. By and large, however, I believe the comparison with competitive markets is valid and fair.

One argument, then, against treating interest rates like other prices in the framework of Phase II guidelines is that unlike many other price increases in our economy at the moment, any future increase in the cost of credit will reflect not cost-push, nor catch-up, but simply increased demand. And failure to permit an increase in price in the face of increased demand would soon lead to the necessity for rationing.

But if this is true for the "commodity" credit, why isn't it true of other commodities as well? Only partly because markets for money are more competitive than most others. The rest of the answer lies in the uniqueness of the New Economic Policy. The whole rationale and justification for the New Economic Policy is the belief that government intervention in a slack economy could break inflation more quickly than was happening through the play of market forces, and thus permit, as I said earlier, a speedier return to full employment.

Many people fail to recognize that the circumstances leading to government intervention this time were entirely different than those that caused the government to resort to controls in the past. On this occasion, government restraints were designed to break an inflationary cycle and an inflation psychology that were persisting despite the existence of a considerable degree of slack in the economy, and indeed the prospect of continued slack for some time. In the past, restraints were introduced in order to keep a lid on prices in the face of anticipated or actual excess demand pressures associated with war. Price controls in the past, in other words, normally had to be accompanied by rationing, because at restrained prices, supplies were inadequate. This is certainly not the case at present, and for this reason we are able to proceed without the much more cumbersome administrative problems that accompany rationing.

As we move back toward fuller utilization of resources and lower levels of unemployment, maintenance of direct restraints on prices and wages will become increasingly difficult. The hope and expectation is that by the time this becomes a problem, the restraints will have succeeded in greatly reducing if not eliminating expectations of continued inflation, so that we will be able to revert to more traditional and market-oriented ways of dealing with economic fluctuations. While we have a long way to go, I do not think this is an unrealistic expectation. And if it works out this way, then we should be able to get through without the rationing of most goods and services.

Nor, in fact, is there much prospect right at the moment that credit would need to be rationed even if ceilings were inadvisedly placed on interest rates. For market expectations seem now to be geared toward declining rather than rising rates, at least in the longer maturities. And certainly, if we are correct in our belief that the rate of price advances will slow markedly in the coming years, this in itself would permit a decline in nominal interest rates without implying an equal drop in real rates. But since expectations play an important role in determining interest rates -- a more important role certainly than for most prices other than for raw materials -- prospects for an expanding economy and rising demands for credit are likely to show up sooner in rising interest rates than in other prices. As a result, ceilings might begin to bite sooner in the credit area than in other sectors of the economy, and raise the kinds of rationing problems that otherwise might well be avoided.

But the case against including interest rates in the same kinds of norms applied to other prices rests only in part on the argument that ceilings at below-market levels will lead to shortages of credit that in turn will bring demands for rationing or some other form of administrative allocation. Perhaps the greater danger is that monetary policy will feel constrained to provide reserves in sufficient amounts to prevent interest rates from rising, regardless of whether or not demands for credit appear to be excessive in terms of the needs of the economy. For the obvious way out of the dilemma of below-market rates leading to scarcities is to see that the scarcities do not arise.

Just as obviously, however, while this may seem to be a way out in the short run, it could have disastrous consequences for the success of the New Economic Policy as a whole. If in fact the economy begins to regain momentum as we all hope, then there will come a time when increased demands for credit will not be able to be satisfied at then prevailing interest rates, and there will be a tendency for interest rates to rise. If this tendency is suppressed through the open-ended provision of reserves, then the pressures that would have shown up in rising interest rates will simply be transmitted to the markets for goods and services, with obvious consequences for the likely success of the President's efforts to end inflation.

There is nothing novel about the line of argument I've just outlined. It is the classic case for a flexible monetary policy. In effect, there is an inescapable choice: as the economy picks up speed, and markets begin to adjust to this fact, either the adjustment is permitted to work itself out in the credit markets in the form of rising interest rates, or demand pressures, financed through credit, will build in the markets for goods and services and translate themselves into rising prices and, as seems likely, the breakdown of the wage/price restraint program. This elementary proposition is worth repeating only because it is so often forgotten by those who look only at the undesirable effects of high interest rates alone. And it particularly bears repeating at the present juncture when we are considering the appropriate role for monetary policy during Phase II.

Perhaps I may seem to be protesting too much, or trying to look too far into the future, for there is no indication at the moment that the Federal Reserve won't be as free in Phase II as in the past to call the shots as it sees them. In establishing the Committee on Interest and Dividends, the Administration has recognized that interest rates are unlike other prices, and must be subject to different kinds of rules. And the Congress, despite some voices to the contrary, seems prepared to accept the validity of this point as well. Of course, for the time being, there is little occasion for concern even on the part of those who worry most about high interest rates, since until the economy begins to pick up more speed, it is unlikely that interest rates will rise in any case. On the contrary, as you are well aware, most interest rates are down fairly sharply from the levels prevailing before the President's announcement on August 15.

If there are strong economic reasons for arguing that monetary policy must retain its flexibility during Phase II -- and indeed I would go so far as to say that any attempt to limit its flexibility would seriously jeopardize the chances of changing inflationary expectations, which is what

Phase II is all about -- I think we must also recognize that interest rates at times have a political importance out of proportion to their economic significance. Even if it could be demonstrated beyond a doubt that flexible monetary policy -- including at a later date the possibility of higher interest rates -- would enable the nation to achieve the goals of Phase II more quickly, and thus speed the time when we could get rid of direct government intervention in the economy, there would still be some calling for ceilings on interest rates, regardless. This is a fact of life that is not likely to be changed during Phase II; on the contrary, Phase II provides an air of respectability for the old cries.

In facing up to this fact, it may be necessary at some point to concede some ground in order to assure continued flexibility in the broader areas of the money and capital markets. If a trade-off of some sort should become unavoidable, then the possibility of rate ceilings -- at a later date -- on consumer instalment credit loans, and possibly on mortgage loans below a certain size would probably achieve the greatest political mileage while doing the least damage in terms of interference with flows of credit. The psychological advantage of being able to demonstrate concern for the consumer is obvious. Beyond that, there is no denying the added importance taken on by movements in the consumer price index during Phase II, and ceilings on these rates would help at some point in holding down increases in the "cost of living."

Even in these limited areas, of course, ceilings would not be costless. My impression is that the cost would be relatively minor in the area of consumer instalment loans, since here there is little likelihood that the availability of credit would be affected. On the other hand, the cost of assuring adequate supplies of mortgage funds at below-market rates could be substantial. The Federal government is already expending large sums in the form of subsidies to reduce the cost of mortgage money to low-income borrowers. The only way I know of operating with ceilings on an even broader range of mortgage loans, i.e., including conventionals as well as FHA/VA's, would be to increase the sums the government was prepared to spend on subsidies for the duration of Phase II in order to assure continued availability. Apart from limiting the size of mortgages eligible for subsidy, as is now done, some thought should be given to whether national priorities require that housing starts remain at their present high levels as economic activity picks up in other areas. If we remain wedded to the national housing goal established by the Congress in 1968, there is little choice. But perhaps that goal itself should be re-examined.

While I'm on the subject of housing, I'd like to digress for a moment and commend to your attention the study that was recently completed by the Federal Reserve on the whole question of financing housing in the United States. I doubt that you are going to want to read through all of the twenty individual papers that make up the study -- I haven't done so myself -- but there is an overview -- itself nearly 150 pages long -- that contains some ideas that as mutual savings bankers you probably should be aware of. The whole focus of the study was on a search for practical ways of reducing the cyclical variability of housing finance without unacceptable side-effects on the overall policy of economic stabilization. Some of the comments and conclusions are fairly obvious, others are more novel.

A basic conclusion, at least as I read the study, was the following:

> It seems clear that variations in the rate of housing activity have reached a magnitude that is socially and politically intolerable; if moderation of these swings is achieved, however, the goal of overall economic

> stability will suffer unless greater stability in housing activity is accompanied by changes that force other sectors to bear a greater share of the burden.

This I should put in the category of the fairly obvious, but one recommendation for "forcing other sectors to bear a greater share" is more novel. I should emphasize that the study and its conclusions are the work of the Federal Reserve staff, and do not constitute any policy statement by the Board itself. The suggestion is that there be created a business investment fund, into which businesses would be required to channel funds in some proportion to their own investment expenditures whenever it was determined that the economy was in danger of overheating, and that capital investment seemed to be a contributory cause. On the other hand, when the economy needed a boost, as at present, businessmen could withdraw funds from this pool, and thereby in effect reduce the cost of their investment outlays. The rationale for singling out business capital investment is that such outlays are large and cyclically volatile, and <u>not</u> sensitive to general monetary restraints. This is an idea that has intrigued me for some time, and while its main applicability may be in terms of overall stabilization policy, I think you will readily see the relevance for damping the pressures on the capital markets that have so often led to disproportionate declines in financing for housing.

Before leaving the question of possible areas where rate ceilings might at some time be admissible in the context of Phase II, let me make clear that I am in full accord with the decision of the Committee on Interest and Dividends to avoid such ceilings for the time being. As a practical matter, ceilings frequently become floors, and this would hardly be desirable at a time when one would like to see rates decline. As a matter of fact, Chairman Burns in his statement before the House Banking and Currency Committee at the beginning of November, said that in his opinion, the main role of the Committee on Interest and Dividends should be to speed the adjustment of traditionally sluggish interest rates, such as rates on mortgages and consumer loans, to movements in market rates. And in fact, there have been some reductions in instalment loan rates and in mortgage rates in the period since August 15, and possibly there will be some more. Moreover, even when the time comes when interest rates may begin to rise, reflecting the success of the President's policy to spur economic activity, selected ceilings should be conceded only if they are a political price to be paid, as I said earlier, to assure the flexibility of monetary policy in broader areas of the capital markets.

I'm sure it's clear by now that I attach great importance to preserving the flexibility of monetary policy during Phase II, believing as I do that this flexibility may well be critical to its success. But one can also turn the question around and ask in what way the initiation of the New Economic Policy has changed the range of possibilities open to monetary policy. The twin goals of the New Economic Policy, as I said at the outset, are 1) to dispel expectations of continued inflation, and 2) to permit a more rapid return to full employment. To the extent that the New Economic Policy is successful in its first objective, this will permit monetary policy to be more expansive than would have been possible or prudent otherwise, and thereby itself help to achieve the second objective. But despite the obvious feeling of relief on the part of many members of the Federal Reserve team when the President announced his New Economic Policy, there could be no massive shift in policy toward ease. Not only has it remained uncertain how much support the new policy would receive, and therefore what degree of success it might achieve, but more importantly, any sharp swing in monetary policy would have done much to undermine the credibility of the Government's anti-inflation policy itself, before it even got off the ground.

The fact of the matter is, however, that despite some appearances to the contrary, monetary conditions, as they immediately influence aggregate demand, have eased perceptibly since the President's announcement on August 15. In both the longer- and shorter-term sectors of the market, interest rates are down by between three-quarters and one full percentage point. And as you are well aware, there have been two drops in the bank prime rate of one-quarter point each, and one reduction in the Federal Reserve discount rate of the same amount. By the standards that one applies to the credit markets, therefore, there has been a noticeable easing.

If one looks instead at the money aggregates, however, as all of us do nowadays, the picture is much less clear. A great deal of attention has been focused on the fact that M_1, the narrowly defined money supply, was actually declining for a period of nearly three months in September and October. Revisions in the seasonal adjustment factors applied to this series have made the negative numbers smaller, but there is no getting around the fact that growth in the money supply has been well below normal levels ever since the President's announcement. Part of the decline in the early part of the period could be attributed to the large and unusual flows of dollars into foreign central banks that finally triggered the New Economic Policy. But we are still at a loss to explain satisfactorily the recent sharp drop in the growth of M_1.

Frankly, in the absence of a more rational theory, I'm prepared to subscribe for the time being to a black box type of explanation that says simply that whatever it was that caused the abnormal demand for cash balances during the earlier part of the year has now departed as mysteriously as it came. Unsatisfying as this type of explanation may be, the fact is that M_1 is now about back on a six percent growth path for the year 1971 to date. While it's hardly legitimate to choose one's averaging period to suit the case he wants to make, I think the point is worth making that aberrations in the month-to-month levels or growth rates in the monetary aggregates have been accorded more significance in the market than they deserve. And moreover, there has been a tendency to focus on M_1 to the exclusion of the other monetary aggregates which, significantly, during the recent past have been behaving more as one might hope and expect. Finally, in this connection, I would remind you of the statement made recently by Chairman Burns in his talk at the New York Stock Exchange to the effect that the Fed would provide the resources necessary to finance economic recovery.

As a footnote to this discussion of the monetary aggregates and their erratic behavior during the past year, let me say that I shall be very interested in the explanations of these events by those whose life is dedicated to the proposition that a stable relationship exists between one or another of these aggregates and the course of events in the real economy. I think we have all benefited from the greater emphasis that has been placed on the aggregates in policy deliberations, but I confess that until some more reasonable explanation has been adduced for recent events than a crude black box, I shall remain more a sympathetic skeptic than a true believer at the monetarists' altar.

In any case, those who might be inclined to interpret the slow growth in the aggregates during the past few months as indicating that the Fed is sitting on its hands waiting to see whether the New Economic Policy will succeed in snuffing out inflation before we move toward somewhat easier conditions would simply not be correct. We all know that there will continue to be uncertainty as to the ultimate effectiveness of the President's new initiative, probably even long after Phase II is history. But despite the inevitable questions and misgivings that we all have about details of the President's policy, I for one think we are far better off contending with the difficulties of Phase II than we would have been trying to cope with the frustrations of drifting gradualism. In my opinion, this is certainly true for monetary policy. For if there is some question as to whether the independent judgment of the Fed may be circumscribed by the political exigencies of Phase II, then this is a risk I am prepared to run in the belief that the country has a better chance to achieve the goals that we are all seeking at the moment within the framework of Phase II than without it. Moreover, I think the risk of reduced flexibility for monetary policy is small, since I can hardly believe that the Administration would tolerate the hobbling of one of the major policy instruments for insuring the success of the New Economic Policy. And success is crucial -- in a very real sense, Phase II may be our last chance for a return to a free economy. While it may sound paradoxical, I happen to believe that Phase II, with all its rules and regulations, offers the best assurance of a continuing free economy in the long run. If Phase II fails, the alternative is not likely to be the return to a free economy, but rather the invitation to a much more regimented one. So long as the Fed is left free to do its part, there is no question that it will bend every effort to see that this unthinkable alternative never becomes a reality.