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Perspective on Interest Rates and International Monetary Reform

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PERSPECTIVE ON INTEREST RATES AND INTERNATIONAL MONETARY REFORM

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(EDITOR'S NOTE: Mr. J. Dewey Daane, member of the Board of Governors of the Federal Reserve System addressed the Municipal Bond Club of Philadelphia on Wednesday, May 3, 1967. In response to numerous requests, his remarks are being reproduced in this special supplement.)

I am very pleased to have the opportunity to address this distinguished group, including many of my good friends and mentors, like Karl Bopp and George Kneass, with whom I have been associated for many years.

Although George Kneass, along with your President "Jack" Dempsey, twisted my arm to make some comments on interest rates as well as on international monetary reform, I am sure none of us realized that I would be speaking at a time when the books were still open on a Treasury financing and also, of particular importance to this group, bidding in process for the Commonwealth of Pennsylvania Turnpike bonds. Thus I do wish to emphasize at the outset that I am *not*, and I hope understandably so, *not* going to forecast—or even attempt to—the future of interest rates, or the future of Federal Reserve policy. Nor will I be releasing these remarks publicly at this point, not because I will be saying anything either startling or super secret, about either domestic or international developments, but simply because, as all of you know, when a Treasury financing is in process the Federal Reserve normally follows what is euphemistically called an "even keel" policy. And in my opinion, "even keel" might well be redefined to include no public speeches by Federal Reserve Board Governors! The market deserves at least that much surcease from the flow of words!

I do, however, want to begin by making a few observations as to the economics of interest rates. Art Okun, one of the members of the President's Council of Economic Advisers, sometimes says that what we are, or should be, concerned with is not "old" economics or "new" economics but "good" economics. And today I thought I might take this opportunity to outline what I consider to be "good" economics regarding interest rates.

First of all, interest rates do *not* have a separate, autonomous, identity apart from the availability of funds and the demands upon that availability. The idea that interest rates can be varied by voice or fiat, in contradiction to underlying market forces, ignores this very fundamental fact that interest rates are not independent of, but tied integrally to, the supply and demand for funds. To complain that there must be a better way of allocating funds than via interest rates simply means that one wishes to substitute

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arbitrary judgments and a controlled rationing process for market forces. This is surely something I would not want to see and I am sure you would not either. The implications of this point in the recent and current setting are, I hope, clear; it is not only preferable but clearly more realistic to rely on competitive market forces to adjust interest rates—within the framework of reserve availability—rather than to attempt to adjust rates through concerted changes in ceilings by regulatory authorities.

Second, and related to this, the Federal Reserve is *not* the primary determinant of interest rates, either in terms of rate levels or changes in rates. It is true that Federal Reserve policy affects interest rates (among other things) *but*—and this is an important qualification that frequently is overlooked—the range within which the System can influence interest rates as part of a policy of promoting sustainable economic growth is very much determined by the basic economic environment, by expectations regarding the outlook for that environment, and by the actual supplies and demands for funds that reflect both the environment and its prospects. The System can only add or subtract a marginal, albeit important, fraction to the basic equation.

To be sure, since the System is inevitably always a part of the demand and supply, we must always be conscious of, and have some concept of, where the initial impact of our actions supplying or subtracting reserves may impinge. For example, there may be times when, in the light of continuing balance of payments strains alongside inadequate domestic economic growth, it is advisable to tailor System reserve supplying operations in such a way as to minimize downward pressures on short term rates.

A practical illustration of the point I have been making—that interest rates are basically determined by market forces and cannot be determined by fiat or legislation—is suggested by some of the disparate rate movements that have occurred in recent weeks. As you all know, the System began easing policy last fall and has continued on an "ease" course ever since—most recently reaffirmed by the discount rate reduction of a few weeks ago. There has been no change in our policy objectives of combatting weakening tendencies in the economy, or promoting renewed expansion, to the extent a monetary policy of ease can do so. Despite continuance of this policy of ease, however, and its reflection in greater reserve availability and rapid credit expansion, some interest rates have once again firmed markedly and widely differing patterns of rate behavior have emerged in specific sectors of the market.

To recall, quickly, recent rate developments with which you are all familiar, yields on some new and recently offered corporate and municipal bonds have advanced as much as 30 basis points in the past few weeks, reflecting a rash of syndicate terminations, the generally slow reception accorded many recent new issues even at currently higher yields, the still congested state of underwriters' inventories, and the heavy volume of offerings still to come on the forward calendar. To illustrate, reoffering yields on new AA-rated electric utility bonds with five-year call protection have advanced to a new 1967 high of 5.60 per cent. This is 22 basis points above the end of March level, and some 55 basis points above the low reached at the end of January. This rise from the 1967 low has erased more than half of the earlier overall decline from the 1966 high of 6.05 per cent reached at the peak of market tensions last August.

The sharpness of this recent advance in bond yields has reflected the interaction of several major influences:

At the beginning of April underwriters of both corporate and municipal securities held substantial unsold balances of recently offered

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new issues which they had taken on at declining interest rates in the expectation of being able to resell to investors at still lower rates—following the anticipated cut in the discount rate, and after some expected moderation in new issue volume from the hectic March pace.

Following the discount rate cut in early April, however, these earlier expectations of further interest rate declines began to be called in question. Market opinions on the business outlook for the second half of the year were suddenly strengthened by the unexpectedly favorable business news, and by the reports of likely further escalation of the war in Vietnam. At the same time, large further additions to the new issue calendar—in both the corporate and municipal markets—made it look as if there would be no significant respite from business and state and local government demands on capital markets—at least through the second quarter.

Given these changed conditions, underwriters terminated syndicates and sought to liquidate their holdings of older issues in order to be in a position to participate in new offerings at higher rates. But shifting expectations on the business and interest rate outlook, the heavy volume of current security offerings, and further additions to the forward calendar of future offerings all continued to maintain upward pressures on rates. Thus, despite their efforts to trim inventories, underwriters have continued to end up with sizeable holdings—particularly in the municipal market where inventories are in near record volume.

The particular catalyst that has triggered this mix of influences is, of course, the growing expectations that business is strengthening, and the resultant view that the cyclical down-swing in long-term rates may have ended. In these circumstances investors have become reluctant buyers, waiting to see if the heavy forward supply will force rates higher; underwriters have pressed to try to liquidate positions; and some borrowers in both corporate and municipal markets have apparently accelerated their borrowing plans in an effort to satisfy their needs before an anticipated further change in market conditions.

Speaking more generally, we now seem to be living through a period of a whole sequence of reactions to the strains of last summer, strains from which you as market participants and we as monetary authorities have, I hope, learned a number of lessons. And one reflection is evident in the emphasis placed on restoring liquidity as the first, and quite natural, reaction to the easier availability of money against the background of last year's developments. For example, this is evident in the changed behavior of bank demand, in turn in part reflecting unwillingness to seek larger inflows of CD money. Thus, despite the substantial shift in Federal Reserve posture—as noted in the shift from average net borrowed reserves of $430 million last October to a recent average of well above $200 million free reserves—active bidding for shorter term Treasury bills and shorter term municipals has contrasted with conditions in the long-term markets which at times have been characterized as "nothing" markets.

Thus, while the disparate rate movements remain an interest phenomenon, they are an understandable by-product of the concern that developed, and of the shift in expectations, which has meant a differing pattern of rate changes as between short and long term securities. As I said at the outset, I am not trying to offer a full blown theoretical or practical explanation so as to pretend to identify and predict the course of interest rates, but simply to highlight that current developments serve once again to underscore the truism that the market is bigger than any of us and that market expectations and related actions are, more often than not, all important.

What has occurred represents, in part, the

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element of reaction to expectations, expectations that, in my judgment, are unfounded at least in the sense that the one thing of which I am sure is that events never repeat themselves in precisely the same way. But just as significant as the expectational catalyst, however, and not unrelated to it, has been the actual supply of securities offered in the various markets. In the market for new publicly offered corporate bonds it now looks as if the April calendar will aggregate in excess of $1.3 billion, which compares with the $1.7 billion March record. The May calendar already exceeds $1 billion and some think it may ultimately rise to $1.5 billion. Similarly, with the June calendar of scheduled offerings already at $800 million, it too may ultimately exceed $1 billion. In short, gross public offerings of corporate bonds for the first half of 1967 may total nearly $7 billion, compared with gross offerings of $8 billion in the entire year 1966. As to new State and local government bonds, offerings in April are estimated to have exceeded $1 billion for the fourth consecutive month. And, as you know all too well, gross municipal offerings through the end of April are estimated at $4.7 billion, 15 per cent larger than in the like period a year ago.

This recital of details as to public offerings is not intended to sound alarmist over either recent or prospective resultant rate developments. One partial offset to the enlarged flow of public offerings has been a drop in private placements. In the first half of the year these may run around ½ to ¾ of a billion dollars below the first half of 1966. And the unprecedented concentration of public offerings in the first half—not unrelated either to the repayment of bank debt (reportedly accounting for over 40 per cent of first quarter offerings) or to the build-up of liquid asset positions—suggest a tapering off in corporate issues of this type sometime later in the year. But my point here is a simple one, namely that it is the underlying market forces, including both environment and expectations, that have accounted for these most recent rate developments. Such underlying forces are real, not illusory, and if at times the market temporarily overdoes its adjustment to such pressures, in the long run they must be adapted to if markets are to remain free and competitive.

Not so simple at the moment is the picture with respect to the relationship of the various credit markets. A major complicating factor in the analysis of recent credit developments is the marked change in the role played by banks. In a sense, it appears as if banks, in a dramatic about face from their 1961-65 practice, recently have been borrowing long and lending short. On the lending side, despite rapid overall credit expansion, there has been, after adjustment for normally large tax payments, a reduced rate of growth in business loans in 1967. Banks obviously have been engaged in restoring portfolio liquidity, as reflected in the large increase in security holdings —about $9 billion—in the last five months. As to sources of funds, total time and savings deposits at banks rose sharply from last fall and were the major source of funds used to rebuild liquidity. The increase was particularly rapid until mid-February, with over one-half of the increase coming from large denomination negotiable CD's. Since February, however, both CD and total time and savings inflows have moderated; all of the growth in CD's in this latter period appears to have occurred at banks outside New York City.

This slower growth in CD's at the larger banks reflects, it seems to me, two main factors. First, the continued increase in time deposits other than negotiable CD's and the turnaround in savings deposits have served to maintain a rapid inflow of funds without the use of large CD's. Second, with loan demands requiring a smaller share of deposit growth, with security portfolios rising, and with declining market yields on the short-term assets banks were acquiring, the need

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and desire to seek large CD's aggressively has tended to wane at most banks. Thus, in the last two months or so, banks lowered their marketable CD rates sharply, to levels that reduced appreciably the level of CD yields relative to competing financial assets—including the CD yield in the secondary market. With rates at levels indicating that banks clearly were no longer anxious to attract large CD's, outstandings rose by only $800 million from mid-February to the end of March. Over the first three weeks of April—with CD offering rates 10 to 30 basis points below secondary market yields on CD's—outstandings declined by almost $600 million—almost three-fourths of which occurred over the tax week. Last week, offering rates were generally unchanged and outstandings at banks in New York declined an additional $27 million. And despite the reduction in outstanding CD's, New York banks, on balance, continued to repay Euro-dollars in April.

This reference to Euro-dollars leads me to comment that, just as in the case of the domestic sphere, international rate relationships also primarily reflect changes in basic environmental economic conditions and expectations along with monetary policy moves, and these relationships correspondingly shift with these internal developments in individual countries. All of this is by way of saying that the spread of downward central bank rate adjustments since January was a to-be-expected response to the changing availability and demands for funds already in process before last year end, as many European economies also began to experience a slowdown in economic activity. The resultant international flows of funds, reflecting the variety of changes in availability and rates here and abroad is, I believe, well known. Looking back, most marked was last year's inflow into the United States of around $2½ billion from foreign branches of U.S. banks—leading in turn to a small surplus in our balance of payments on an official settlements basis for the year 1966. Before year end 1966 we began to see those funds flow out again—perhaps to the extent of nearly $1 billion by early February. Following two months of little or no movement, in April there was a moderate outflow again. All of this would indicate that the published statistic for the U.S. balance of payments deficit on an official settlements basis could hardly be expected to look very favorable in the first quarter or first half of 1967. As to our other principal payments balance measure—the overall liquidity basis—it is more difficult to sort out and anticipate possible results. One can, however, suggest that it is a matter of striking a balance between offsetting developments on current and capital account. Trade developments thus far this year point to an encouragingly larger trade surplus. On the other hand, some deterioration is expected in military expenditures and in the net capital outflow.

The balance of payments problem—however it may turn out to appear statistically in the first quarter—remains a serious one. And here I would like to clear up any remaining confusion as to the relationship of our balance of payments problem to our current efforts to bring the search for an international money to supplement gold and dollars to a successful conclusion.

The plain fact is that there is no real connection between our current balance of payments financing problem and the problem of creating a new international reserve asset to provide a supplement to gold and reserve currencies. There is simply no international liquidity escape route from the hard road of restoring equilibrium in our balance of payments. And I would submit that the continuing and increasingly comprehensive efforts made to reduce the U.S. balance of payments deficit in themselves serve as a denial of the asserted escapism. Furthermore, the modest amount of reserve assets that would accrue to the United States under any plan, as well as the

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delay in actual creation of new assets in any realistic timetable, underscores the irrelevance to current deficits.

In plain fact, it is simply inconceivable that the United States could go on running significant deficits on the basis of our share in any new reserve asset creation. Moreover, so far as the immediate situation is concerned, I can see no prospect that the many remaining preliminaries can be completed, and actual reserve creation initiated, before 1969 or 1970. So neither the Europeans who are skeptical of our motives, nor the Americans who have indulged in wishful thinking, should be misled concerning the real nature of our genuine interest in reserve creation as a fundamental improvement necessary for the international monetary system, not as a crutch for the United States.

Then *why* are we searching for ways and means of deliberately creating, for the first time, an international money? The answer is relatively simple—it is because there will not be enough of the existing kinds of reserve assets to go around. The present sources of increases in international reserves are, it is generally conceded, likely to prove inadequate over the years ahead and global reserve shortages could have deflationary effects and lead to restrictive external policies that could only serve to reduce growth of world trade and of the world economy. The world needs the assurance that the traditional reserve assets, gold and reserve currencies, can and will be supplemented by a new reserve asset as needed to meet future requirements.

To illustrate, during the past decade, roughly, the increase in world reserves has averaged close to $2 billion a year. If one excludes the United States which has experienced a substantial decline in reserves, reserve growth of the rest of the world has averaged nearer to $3 billion a year. But analysis of trends in the principal components of that reserve growth point to the likelihood of future difficulties. Taking new gold first, there has been very little addition to international reserves from this source in recent years—perhaps 200 to 300 million dollars a year. And, last year there was actually a net drain from monetary reserves into nonmonetary uses—reflecting increased industrial uses associated with space, jewelry, etc., and, undoubtedly, continued speculative demand. So gold alone does not seem to provide the answer to the need for growth in international reserves as we look ahead. What about dollars—or about some other currency performing this function? Again, there are clear indications that growth in foreign official dollar balances alone, or in combination with new gold, cannot meet these prospective needs. For substantial dollar growth could mean continued overly large official settlements deficits in the U.S. balance of payments to provide such an outflow. Yet, such deficits—unless accompanied by net *increases* in U.S. reserve assets—are clearly undesirable, for they can only serve to weaken the value of the dollar and lead more and more to an unwillingness of foreign monetary authorities to accept, or at least to hold, such dollars in their reserves. In the past two years, monetary authorities of the major industrial countries have, in fact, *not* added to official dollar holdings in their reserves. Instead, as most of you know, there has been a substantial conversion of dollars into gold and, although mainly reflecting the policy and actions of one country, this results in a corresponding reduction in total international reserves. The *why* of our search, therefore, is the strong evidence that the supply of reserves from traditional sources—mainly gold and dollars—will not be enough to meet growing needs.

As to any other national currency filling the breach, apart from the special role of sterling, all major countries have made clear their unwillingness and inability to accept the burdens of a

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reserve currency country. Thus it is only prudent to look elsewhere—and it is this prudent look that has been, and is, called "contingency planning" for reserve asset creation.

Finally, it may be asked, where is the search taking place and what are the prospects for success? The *where* question is the easiest to answer, but not the least important, for it sets the stage for at least one of the key issues remaining, namely, how the decision-making process, in terms of both the establishment of a plan to create assets and its activation, will be determined. Speaking generally, the search for ways and means of deliberately creating reserve assets to supplement gold and reserve currencies in the international monetary system has been going on for several years, most meaningfully in two forums—which have now been joined in this effort—the so-called Deputies of the Group of Ten (the deputies to the finance ministers and central bank governors of the ten leading industrial countries) and the International Monetary Fund itself for, as Managing Director Pierre Paul Schweitzer has often said, "international liquidity is the business of the Fund."

Beginning last fall these two groups joined efforts and a series of joint meetings of the Deputies of the Ten and Executive Directors of the IMF has been held, the first in Washington at the end of November, 1966; the second, in London near the end of January, 1967; the third, again in Washington last week; and a fourth and final meeting scheduled for Paris in mid-June. Against the background of all the efforts to date and of these most recent joint meetings, what can be said as to the progress made and hopes for the future?

The answer here is *not* such a simple one because it involves the current negotiations and a number of still unresolved issues. But I believe that it is fair to state that great progress has been made. Consider the broad, and important, areas of agreement:

First of all, there is now a unanimous consensus on working ahead toward the establishment of a plan for deliberately creating reserve assets to provide for adequate secular growth in reserves.

Second, it is generally agreed that the creation of such reserves should be designed to meet the global needs of all Fund members, not the balance of payments needs of any individual country. And there is agreement, too, that reserve creation should not be linked to development assistance.

Third, there also seems to be general support for the principle of universality—that is, that any asset created will be distributed to, and available for use by, all countries not just a privileged few. The consensus on this score seems to lean toward distribution to all member countries of the International Monetary Fund according to a generally objective formula such as IMF quotas. No clear view has yet emerged as to the relation of universality and decision making but here, too, gratifying progress has been made in discussing and exploring the possibilities.

Fourth, as to the more specific and technical questions of the nature and form of the new asset it is now also generally recognized that the two principal types of reserve assets that have been discussed—one a new reserve unit and the other a new drawing right claim on the Fund—can be made nearly identical in technical properties. But there are important questions remaining as to the precise construction of an unconditional reserve asset that will clearly and effectively serve as a true supplement to gold and dollars. Those favoring a reserve unit approach point out that it can more readily do just that.

But apart from, although not unrelated to, the question of the choice of approaches a number of important issues remain to be resolved:

First, the question of decision making with

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