

*The Budget,
Regulation Q,
and Gold:*

Three Issues for Today and Tomorrow

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65th Annual Convention of the New Jersey Bankers Association
May 23, 1968

Supplement to Business Review, June, 1968

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So much has happened in banking and finance since we last met that it is difficult to choose which of many current events to talk about. Meanwhile, critics of the Federal Reserve System, whatever their leaning, have had a field day. By choosing the measure that supports his view, the critic can prove almost anything—to his own satisfaction—but not to the satisfaction of other critics who choose another measure.

For example, those who believe simply that the Federal Reserve controls the money supply and that the money supply controls everything else in the economy insist that the Federal Reserve began a disastrously easy money policy about the time we met here last year. They conclude we followed an easy money policy because last spring and summer the money stock was increasing at a near-record rate of 9 per cent and total member bank deposits at a rate of almost 12 per cent.

On the other hand, those who believe simply that the Federal Reserve fixes interest rates and that interest rates fix the rest of the economy describe that same period as one of extremely tight money because interest rates rose even faster than in 1966 and to the highest levels in decades.

Incidentally, it is a bit—well—disconcerting to learn that in some cases the same individuals who a few years back criticized us severely for not paying enough attention to rates are now criticizing us for paying *any* attention to rates at all, but such is the life of any banker—central or commercial!

My view is that neither central bankers nor observers should measure policy or the need for a change in policy by movements in a single or even a few financial variables. The System has been and is continuing to invest large efforts in order to develop a better grasp of the relationships among financial variables and developments in the real economy—which, after all, is the ultimate objective of policy. I am a member of a so-called Steering Committee which has devoted several years with first-class staff assistance to studying possible benefits from a redesigned discount window which, among other things, might reduce administrative surveillance and make changes in the rate more meaningful.

We now publish our policy record approximately 90 days after each meeting of the Federal Open Market Committee. The record and our reasoning are there for all to see.

I shall not, therefore, go into that record in detail today. Instead, I shall concentrate on three interrelated developments—each of which could be a speech in itself. The first might be entitled “The Failure of Fiscal Policy”; the second, “The Dilemma of Regulation Q”; and third, “The Twilight of Gold.” These titles, though over-dramatic, sum up three basic issues of the past year and—more important—of the long run as well. Indeed, the thrust of my remarks is that in all three cases we are confronted with pressing problems that not only call for immediate solutions, but have important implications for the longer run.

The Budget

Most—if not all—of our current financial problems stem from the failure to get timely changes in fiscal policy. Substantial and continuous budgetary deficits, in an economy utilizing nearly all of its resources, have been heavily responsible for recent price increases. This renewed burst of inflation, in turn, has contributed to a further deterioration in our balance of payments and further weakening of the prestige of the dollar.

The need for restraint in the fiscal program of the Federal Government has been obvious for many months. Whether one is a New Economist or an Old Economist, the combination of a budget deficit of over \$20 billion, which is what it will amount to in the fiscal year 1968, and a price level rising at an annual rate of 4 per cent spells bad economics.

It also spells bad politics. A tragedy is that differences of political views as to how to close the budgetary gap have stalemated action on both spending and taxes for so long. Because of partisan political considerations, as well as more fundamental philosophical disagreements, lawmakers and administration officials are clinging to their respective concepts of the ideal solution to the budgetary problem and are unwilling to make concessions in spite of the urgency of the situation. This is the short-run failure of fiscal policy.

Perhaps even more serious is the implication for the longer run. Are we to face such grave situations again and again as time rolls on? Although the theory of flexible fiscal policy is just as sound as it ever was, the possibility of it being put to practical use has been dealt a severe blow. This is a great disappointment, particularly inasmuch as the tax cut of 1964 had led many to believe that the principles of flexibility were finally taking hold as a working proposition. The current

stalemate indicates once again that two-way flexibility—use of fiscal policy to restrain as well as to stimulate—remains to be mastered. As a result, some observers of economic developments have become disenchanted and are moving to the view that the best that can be hoped for is to establish a stable fiscal policy and leave responsibility for counteracting swings in the economy to monetary policy. The disadvantages of such a course are obvious when we observe the level of interest rates today. A more flexible fiscal policy remains worth striving for, and I haven't lost hope.

Regulation Q

The second issue with important short- as well as long-run implications is the dilemma of Regulation Q. The Federal Reserve's experience in changing ceiling rates on time and savings deposits is brief and inconclusive. When ceilings were raised in December 1965, they helped make possible a rapid growth of money and credit in early 1966. When they were not raised in the summer and fall of 1966, they helped to produce the credit crunch.

As credit tightens and interest rates rise to historically high levels, commercial bankers find it increasingly difficult to compete at existing ceilings. If, however, commercial bank ceilings are set too high, other financial institutions, subject to various restrictions, may find it difficult to compete with commercial banks. If open market rates rise above the ceiling rates, many investors—principally large investors but increasingly even ones having smaller portfolios—channel funds out of financial institutions and into marketable securities. This disintermediation can have far-ranging effects upon financial institutions and the particular markets which they serve.

The Federal Reserve has just recently raised the ceilings for large-denomination CD's. This indicates clearly a desire to avoid the kind of crunch that occurred in 1966 without precipitating the kind of disintermediation that drained funds out of the housing and municipal markets during the same period. Whether these new ceilings will be adequate only time will tell.

The problems with interest rate ceilings stem largely from efforts of monetary policy to keep the rate of economic growth within sustainable limits. To the extent that appropriate fiscal measures are carried out, the burden upon monetary policy is decreased and the pressure on interest rates is reduced. Therefore, a short-run solution to the problem of interest rate ceilings under Regulation Q is a timely and appropriate fiscal policy to supplement a restrictive monetary policy.

The dilemma posed by Regulation Q points up a longer-run problem which gives rise to it. Principally, this is the imperfection of competition in financial markets. Personally, I would prefer not to be in the business of setting ceiling rates on time and savings deposits. I would rather operate in an economy in which institutions would be free to compete against each other for existing supplies of funds; and price would regulate the allocation of funds.

Unfortunately, the various kinds of financial institutions have special restrictions that govern their activities. Savings and loan associations, for example, cannot invest in corporate bonds. Mutual savings banks can operate only in certain geographical areas. Secondary markets for mortgages are not as fluid as some other kinds of markets. Federal agencies regulate the rate of interest which savings institutions can pay for funds. Furthermore, many states impose usury ceilings on the rates which these institutions can

charge on loans.

Institutional and statutory rigidities which impair efficient functioning of our financial structure are man-made problems; so it would seem that they could be removed readily. As you know, however, artificial and arbitrary market impediments are difficult to eliminate, mainly because of the support they receive from special-interest groups in legislative halls throughout the nation.

Longer-run solutions to the problems of interest rate ceilings are possible. I do not give up on this as an ultimate goal. First, it is desirable to broaden opportunities for the various kinds of financial institutions to compete with each other. This would mean that arbitrary distinctions among types of institutions would be reduced. Second, it is desirable to develop broader and more efficient secondary markets for mortgages and other debt instruments. Improved flows of funds among markets make it easier and more efficient for banks to adjust their asset positions. For example, the better the secondary market for municipal bonds, the easier and less costly it is for banks to use them as a type of secondary reserve.

I believe that usury restrictions deserve special attention now. Originally, usury legislation was adopted to protect the public from unscrupulous money lenders—a goal which is still in favor in this era of concern over consumer protection. I am sympathetic with the principle of aiding consumers; but there is a difference between consumer protection and interest rate ceilings established by usury laws.

Usury ceilings were established in relation to interest rate levels prevailing at the time. Perhaps framers of usury provisions thought that the ceilings were set high enough to present no substantial future problem to borrowers or to lenders.

However, as rates have climbed to historically high levels, the usury limitations *have* become a problem. They may protect the borrower from paying high rates; but in today's markets they are more likely to prevent him from getting the funds at all.

I am reminded of a story from the days of wartime rationing.

A woman went into a store to buy pork chops. The butcher told her the price was a dollar a pound.

"Why your competitor across the street is charging only 75¢."

"Please, madam, why don't you go there to get them?"

"Oh! he doesn't have any to sell."

"Well, when I don't have any to sell, my price is only 50¢."

Because interest rate ceilings vary among states, lenders often find it advantageous to shift funds to other geographical areas. The shift may not coincide with the relative need for funds among the areas. Now, roughly four-fifths of the states have more lenient usury laws than do Pennsylvania, Delaware, and New Jersey.

As you know, new truth-in-lending legislation passed Congress and was sent to the White House yesterday. Knowledge of costs can give real protection to the consumer-borrower. Companion legislation on the state level to remove or substantially revise usury provisions would be timely and appropriate. Recently the Pennsylvania Legislature has raised the interest limitation on mortgage loans in the state. The action may not be adequate, but is a step in the right direction.

I would hope that in the months and years ahead substantial efforts could be devoted toward eliminating the arbitrary, man-made impediments to free competition within and among various financial institutions and markets. Recently, the

Federal Housing Administration raised the ceiling on interest rates on mortgages which it insures. Also, Fannie Mae has instituted an auction process for determining prices of mortgages it buys. These actions are a step toward removing some of the impediments to funds flowing into the mortgage market. More such actions are needed if we are not to be faced periodically with financial disruptions in periods of high interest rates.

Gold

The third issue before us is the twilight of gold. I use the word "twilight" advisedly because the question of gold still sets off a great deal of pyrotechnics. Nevertheless, it seems clear that the role of gold as well as that of the dollar has been weakened by recent events.

In the short run, gold has occupied the center of the stage. The decline of over \$2.5 billion in United States gold reserves since your meeting a year ago is an indication of the difficult state of the U.S. dollar in the world economy.

The liquidity considerations of the United States should not be confused with questions of solvency. Each year our nation grows wealthier in relation to the rest of the world. During the ten years ended in 1966, U.S. investments and assets abroad jumped by 126 per cent to \$112 billion, while foreign assets and investments in the U.S. increased by 91 per cent to \$60 billion. So, the United States with net investments of over \$50 billion in the rest of the world is an economically sound nation—and it has grown stronger year by year. But, we do have a liquidity problem that demands solution.

The gold problem has been caused by a failure of the United States to achieve reasonable equilibrium in its balance of payments with other countries. Over the past ten years the aggregate

deficit in balance of payments has approached \$27 billion. These deficits have resulted from a number of factors. The United States has poured billions of dollars into economic assistance programs, helping war-ravaged nations back to their feet. American corporations, alert to expanding overseas opportunities, have boosted investments in foreign lands. Our rising income levels have enabled more individuals to travel and spend abroad. Our military commitments around the world and particularly in Southeast Asia have been a large drain on dollars. Moreover, foreign nations have stepped up competition with American firms for important markets both in the United States and elsewhere. Domestically, inflationary pressures have encouraged foreign businesses to sell goods in United States markets, thereby putting pressure on our favorable balance of trade. All of these factors have been operating for a number of years.

Our Government has taken a number of short-run, stop-gap measures to stem the outflow of dollars and gold. There is the voluntary foreign credit restraint program with which you are cooperating splendidly. Also, we have the interest equalization tax levied against foreign investments by United States citizens. We have the foreign investment restraint program which asks businesses not to ship dollars overseas for investment purposes. The Government has cut the value of items tourists can bring back duty-free in an attempt to curtail tourists' spending abroad. Restrictions on overseas travel by individuals have been proposed. And the list goes on.

In spite of these stop-gap measures, the near-term outlook for the balance of payments is far from good. The likely increase in economic activity during the rest of the year will continue to produce a large demand for imports. Further increases in prices will make it harder for Ameri-

can producers to export to foreign markets and will entice foreign businesses to increase sales in American markets. Military outlays overseas can be expected to continue at a substantial level even if shooting stops in South Vietnam. And it remains to be seen how much over-all reduction in the balance-of-payments deficit will be achieved by the President's program announced on January 1.

The most important step in bringing the balance of payments closer to equilibrium has not yet been taken. That step is a move toward fiscal restraint. A reduced Federal deficit should help restrain domestic demand, thereby slowing down imports; it should help to hold down domestic prices and thus stimulate exports. Furthermore, it should pay handsome dividends in improved psychology around the world with respect to the health of the dollar.

Looking to the longer run, progress toward establishing special drawing rights is an encouraging development. The supply of gold is too uncertain to provide a base for a growing world economy, and it is clear from recent experience that there are limits to how far dollar liabilities can be expanded through balance-of-payments deficits.

The new "paper gold" is another step in the evolution of a more viable international monetary system begun with the creation of the International Monetary Fund. As this system has evolved, gold has been a declining portion of world monetary reserves—from 72 per cent in 1948 to 56 per cent in 1967. The "paper gold" will be a further supplement to gold, enabling world trade to grow in a more orderly way. It is, however, no less vital to pursue other policies which will encourage economic growth throughout the world, and not restrain it. Recourse to quotas and other restrictions on trade would

frustrate these very promising efforts.

The long-run goal of a more viable international monetary system cannot be achieved, however, unless we bring our international payments closer to equilibrium.

Conclusions

There are many lessons to be drawn from recent experience. The one I want to emphasize is the importance of working toward long-run solutions to current and persistent problems. The danger in resorting to *ad hoc* expedients which at best only postpone a showdown is that fundamental solutions may be made even more difficult to attain. I am fully sympathetic to the view that today's fast-moving world calls for great flexibility. Actions of the Federal Reserve System in recent years, in fact, have exhibited more flexibility than in any other period of the Fed's history.

In the case of the Federal budget, efforts should go forward to prevent recurrence of the kind of fiscal impasses that we are now experiencing. In the case of Regulation Q, the Fed will be faced with a dilemma every time interest rates get high and money gets tight. Efforts to make financial markets freer and more competitive are essential if we are not to be confronted with recurring problems of disintermediation and adverse allocation of credit. Finally, in the case of gold, action to put the world's financial system on a more flexible footing should proceed as rapidly as possible. The first step to assure this long-run solution is for the United States to get its balance of payments closer to equilibrium.

We cannot let the house burn down while we design the most efficient water system. But without such a system, we shall be in grave danger each time a fire breaks out.