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Statement by

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I appreciate the opportunity to participate in these hearings on the economic circumstances surrounding the recent increase in the bank prime loan rate. At the outset, let me underscore a point made by prevous witnesses. High interest rates are not a goal to be sought; they are an unfortunate but seemingly inevitable result of inflation. They result from inflation because lenders insist on higher rates to offset expected erosion in the value of the dollar and because borrowers are willing to pay high interest rates in order to buy now what they expect will cost more later.

The way to get interest rates down is to end the inflation that has been raising them. Then we can return to a sustainable rate of economic growth, consistent with the national goals of price stability and full employment of our human and material resources. This is the path back to lower interest rates, even though in the short run actions taken to curb inflation add to upward interest rate pressures through restraint on the supply of credit.

The United States economy has experienced a long period of overheating, in which aggregate public and private demands for goods and services have persistently exceeded the available supply. During this period the nation's labor supply and other productive resources have been pressed quite fully into service. This economic environment has naturally resulted in bidding up of market prices and in strong upward pressures on wages and other costs. The buoyant condition of most markets has permitted price and cost pressures to be mutually intensifying. Costs and prices have tended to climb even more rapidly this year than last, despite some dampening in the economy's real rate of growth. It is clear that inflation, and the widespread expectation of it, is our most serious current economic problem.

In an inflationary environment such as this, the most effective approach to stabilization requires fiscal and monetary policies that work together to restrain excessive demands for goods and services. On the part of fiscal policy, this means that the Federal budget should be in surplus. For monetary policy, it means that the Federal Reserve must hold back on the volume of reserves supplied to the banking system relative to demand, even though in the short run such a policy adds to upward pressures on interest rates. As a result, money and credit will not be available for all those who seek it, and some will postpone their spending plans.

In this course of events, as credit demands outpace restrained credit supply, virtually all interest rates tend to rise. Some rise sooner than others. Some rise more than others. The timing and rate of rise depends in part on where credit demands happen to be focused, on market attitudes, and on the degree to which inflationary expectations have taken hold and have affected the spending and financing plans of businessmen, consumers, and State and local governments.

Thus interest rate increases reflect market forces in an inflationary environment, and are also part of the process by which policies of monetary restraint become effective. We cannot reduce the growth rate of the supply of money and credit without affecting interest rates; as the supply is restrained, the price will adjust upward until the demand for credit is also curtailed.

The recent rise in the rate charged by large banks to their prime loan customers was decided upon by the banks in light of market conditions, and it is not up to the Federal Reserve to pronounce judgment of either approval or disapproval upon that decision or other particular interest rate movements in the market.

When monetary and fiscal restraint causes excess demands to abate, and calls into question the easy assumption of rising profits based on inflation, then credit market pressures will subside. It follows that credit costs, including bank lending rates, will then no longer be under upward pressure and should come down.

Essential to the abatement of present credit market pressures is a resurgence in the public's willingness to save in the form of fixed income financial assets--a development which depends on restoration of a stable economic environment, so that the real value of fixed dollar assets will not continue to be seriously eroded through inflation and capital losses. Also essential is a dampening of the desires of businessmen to borrow and finance the building of plant and equipment now in anticipation of rising prices and costs later.

As part of the effort by monetary policy to complement fiscal policy in reducing inflationary expectations and spending, the Federal Reserve discount rate was raised last December to 5-1/2 per cent, and then again in early April to 6 per cent. But the primary effort of monetary policy has been to restrict the growth of bank reserves through open market operations and reserve requirement increases (reserve requirements on demand deposits were increased 1/2 per cent in April), rather than through increases in the cost of borrowed reserves.

Over the first five months of this year, nonborrowed reserves of the banking system--i.e., those reserves provided through System open market operations--have declined, following a substantial rate of growth in the second half of 1968.

Banks have added to their reserves by increasing their borrowings at the Reserve Bank discount windows, as normally occurs in periods of growing monetary restraint. The discount facility is intended to be available for the temporary accommodation of member banks in need of funds, to help them meet exceptional seasonal pressures or to give them time to make more fundamental adjustments in their lending and portfolio investment policies. But even taking account of the rise in borrowings, total reserves of the banking system grew at only about a 1 per cent annual rate during the first five months of the year, in contrast to almost a 10 per cent annual rate during the second half of last year.

This restraint on the potential expansion of bank deposits and credit took place in an environment of continued strong credit demands. During the first quarter of 1969, the domestic nonfinancial sectors of the economy, apart from the Federal Government, raised somewhat less funds than during the record fourth quarter of 1968, but more than in the third quarter of that year and substantially more than in any previous quarter for which we have figures. And in security and mortgage markets, slightly more funds were raised in the first quarter of this year than in the fourth quarter of last year. We will not have complete data for the second quarter for several weeks, but partial information suggests that credit demands continued strong and that any reduction in the volume of funds raised reflected mainly supply constraints.

With respect to bank loans, business loans rose at almost a 17 per cent annual rate in April and May, about the same as in the first quarter and up from a 14 per cent growth rate in the second half of 1968--all high rates of increase based on the historical record. In part these heavy second quarter demands reflected the need to meet large tax payments. But in addition, the sharp tightening of conditions in bond and short-term credit markets led many borrowers to take down loan commitments they had from banks. Illustrative of these tight conditions is the rise in the interest rate on 4-6 month commercial paper from a high of 6-1/2 per cent at the end of last year to well above 8 per cent recently, and in yields on new high grade corporate bonds from an already advanced level of nearly 7 per cent to around 7-1/2 per cent over the same period.

Faced with exceptionally strong demands for credit, banks have found it increasingly costly and difficult to obtain the funds to accommodate such demands. Deposit inflows thus far this year have been held down by the restricted availability of reserves and by the refusal of the Federal Reserve to raise Regulation Q ceiling rates and thereby increase the availability of funds for the expansion of bank credit. There has been a substantial attrition in the dollar volume of large time certificates of deposit outstanding, which has exerted pressure particularly on major money market banks. Moreover, net inflows of other time and savings deposits have slowed down markedly, affecting the banking system more generally. And through May of this year, the money supply has grown at a quite modest annual rate of a little more than 2-1/2 per cent.

As you are well aware, individual banks have turned to other markets in an effort to obtain funds. Borrowings abroad in the Euro-dollar market have risen sharply, but at substantial increases in cost. Last week 3-month Euro-dollar interest rates averaged above 11 per cent, up nearly 4 percentage points since last December; the amount of such Euro-dollar liabilities used to finance head-office needs is now in excess of $13 billion, more than double the amount of such borrowing at the beginning of the year. Indeed, the rise has been so rapid that the Board last week proposed a new regulation that would impose a reserve requirement of 10 per cent on Euro-dollars obtained to finance domestic credit expansion over and above the amounts already acquired by May. The increases in recent weeks have been so large that they no longer represent a safety-valve protecting against sudden and undue tightness in the financial situation of individual large banks, but rather an escape hatch through which necessary restraints are being avoided. We hope that the new proposal will correct this.

The Federal funds rate--the rate on domestic overnight interbank borrowing--moved up to over 9 per cent, almost 3 percentage points more than in December of last year, and the volume of this borrowing has also increased substantially in recent months. And in a new development, some banks have begun to make the Federal funds market available to their corporate depositors as a means of providing them with interest on short-term funds. In the Board's judgment, there is no justification for a bank's liability on such transactions to be exempt from rules governing reserve requirements and the legal prohibition against payment of interest on demand deposits, and we published Friday a proposed revision of Regulations D and Q to make sure this is covered.

As part of their adjustment to the restricted availability of reserves, banks have also sold U. S. Government securities and withdrawn from the municipal market. This has involved capital losses on securities sold in an adverse market or in interest foregone as securities available at very attractive rates could not be purchased. The improved budgetary position of the Federal Government has helped to moderate pressures in the market for Federal debt. In the municipal market, however, yields have risen almost a full percentage point from already advanced December levels.

Under these conditions, banks clearly have an obligation to conduct their affairs in a manner consistent with Government stabilization policies. I believe that the word has gotten out to the banks that the Government means business in its efforts to bring inflation under control, although the delay in extending the surtax could lead again to some misunderstanding on that score. Bankers must cooperate in the fight against inflation; they must be more willing to turn down loans to which they are not already committed, and they must strongly resist making further new commitments. If they show more restraint in extending business loans, as I hope and trust and urge that they do, they will not have to make such large adjustments in the other markets in which they are active, such as the municipal and mortgage markets.

It is not too much to hope that businessmen, too, are having second thoughts about the wisdom of counting on a continued inflationary boom to justify unrestrained spending on plant and equipment. There are now signs of a moderation in their spending plans. The latest official survey, for example, shows that planned investment expenditures for the second half of this year will grow much more slowly than in the first half. By the fourth quarter, the survey shows such outlays rising at an annual rate of only 3 per cent, compared with rates close to 20 per cent in each of the first two quarters of this year. I sincerely hope that these survey findings will prove to be accurate, both because moderation is the best policy for the health of the economy and because I believe that it would be a mistake for businessmen to count on being bailed out by inflation in the years to come for investment errors they make in 1969.

Mortgage markets thus far in 1969 have not borne the undue share of restraint that they did in 1966, thanks partly to the increased flexibility and better relative competitive position of nonbank savings institutions under current ceiling rates and to the various support programs of the Federal Home Loan Banks and FNMA. Still, the deposit experience of the thrift institutions, as well as the banks, might be more adversely affected if rates in the security markets were to be forced up by heavy bank selling of Government and municipal securities.

If things turn out as I hope they will--if bankers and businessmen recognize that their own interests coincide with the public interest in calling for restraint and if their lending and spending decisions work in harmony with fiscal and monetary policies aimed at cooling the boom--we can check the drift toward higher prices and higher interest rates. I believe we can stop inflation (and reduce interest rates) without establishing programs--voluntary, semi-voluntary, or mandatory--designed to control the allocation of credit among types of borrowers.

I share your concern over the impact of high interest rates on particular markets, such as the mortgage market and that for municipal obligations, but I do not think that a control program is the answer under current circumstances. It is extremely difficult, perhaps impossible, to design a nationwide control program of that sort that avoids inequities--in the selection of base periods and institutions to be covered, for example. Voluntary programs run the risk of penalizing those who cooperate, if their competitors cooperate less fully. Mandatory programs tend to become increasingly complex and costly, and progressively less effective, the longer they run. And it may be worth recalling that programs that work in countries with only a handful of banks might not work here, just as the effectiveness of the Voluntary Foreign Credit Restraint Program, which involves a relatively few large banks, might not be attainable in a domestic program involving all of the 13,000-plus commercial banks in the country.

I am optimistic about the prospects for success in our stabilization efforts without direct controls, and I am not advocating them now, even though I recognize that we may have to resort to them if current efforts do not succeed.

We are making progress toward our goal of regaining the basis for balanced, noninflationary economic growth, even though prices are still rising rapidly. The rate of growth of aggregate demand, as measured by GNP data, diminished from an annual rate of 10 per cent in the first quarter of 1968 to 7 per cent in the first quarter of this year. And there are now signs of less intense pressures in labor markets and, as I mentioned, of moderation in businessmen's spending plans.

As the economy becomes less feverish and inflationary psychology is dispelled, we can expect this to be reflected, and possibly anticipated, in a scaling down of credit market pressures--a development that is a necessary precursor to any general downward movement of interest rates.