Authorized for public release by the FOMC Secretariat on 3/17/2020

RECD IN RECORDS SECTION
NOV 21 1961

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON 25, D. C.

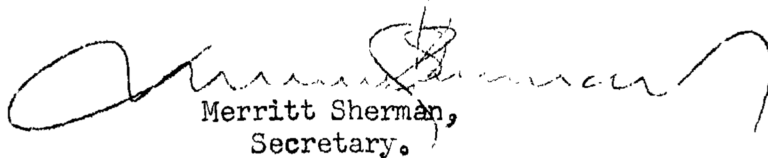
ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

November 20, 1961

Dear Sir:

For your information, there is enclosed a copy of a memorandum on Credit Needs for Economic Expansion, prepared by Mr. Thomas for presentation to the Federal Advisory Council.

Very truly yours,



Merritt Sherman,
Secretary.

Enclosure

Authorized for public release by the FOMC Secretariat on 3/17/2020

Not for Publication

November 20, 1961.

REC'D IN RECORDS
NOV 21 1961

CREDIT NEEDS FOR ECONOMIC EXPANSION

For the past nine months, the U.S. economy has been in the process of recovering from a mild recession and of advancing to new high levels of activity. At present, there are still unutilized resources of productive equipment and particularly of manpower. Potentials for further expansion without placing undue pressures on resources are, therefore, still sizable.

Potential expansion in economic activity.

These potentials have provided the basis for a large number of projections or forecasts, nearly all of which indicate the possibility, or likelihood, of further increases in GNP of 7 to 10 per cent in the next 12 to 15 months -- in dollar terms, about $40 or $50 billion. A pattern of this sort, for example, is implicit in the estimates of Treasury receipts presented in the mid-year budget review.

Differences among analysts exist not so much with respect to the magnitude of over-all expansion that might occur as with respect to the forces or policies that may help to bring about the projected results.

It is generally assumed that Federal Government expenditures for goods and services will increase by fully as much as indicated in the mid-year budget review -- in annual rate terms, $5 billion or more from present levels or about as much as in the past year. Expenditures of State and local governments are expected to continue the rather steady

Authorized for public release by the FOMC Secretariat on 3/17/2020

upward trend that has characterized earlier years -- about $4 billion a year. The estimates assume or predict an expansion in business capital expenditures at a rate which is substantially in excess of the intentions of businessmen expressed in the recent McGraw-Hill survey, which indicated a 1962 total only 4 per cent above that for 1961 and little above the present level. Also somewhat larger business inventory accumulation is assumed than was indicated by the business intentions survey of Fortune magazine on this item. In any event, inventories must increase at an accelerating rate to continue to be an element of over-all expansion. Any such development would be unsustainable and thus present a threat to stability. Residential construction is counted on for a moderate stimulus -- perhaps more than can be predicted with confidence.

To reach the potentials for over-all expansion and to assure that any expansion will be sustained, over half of the increase in total GNP -- or around $25 billion -- must consist of additional consumer expenditures. Latest sample surveys of consumer spending plans for durable goods do not portend any great increase in that area. Whether consumers can be counted upon to increase expenditures as rapidly as in the past is a debatable question of strategic import.

To <u>predict</u> an expansion of the magnitude and type that is being <u>projected</u> requires a certain amount of faith either in the normal tendency of economic activity to increase or in some theory as to the operation of autonomous forces.

Authorized for public release by the FOMC Secretariat on 3/17/2020

Some analysts believe that increased Government spending induces a multiplier effect on other types of spending and they would rely on that source to bring about the desired increase in total Gross National Product. At the same time economic recovery is being counted upon to balance the budget at the presently contemplated level of expenditures. Can both ends be attained? A few have faith in the effectiveness of credit availability as a stimulant, but international interest rate relationships preclude the use of the easy money weapon as generously as in the past. Besides the normal time for that approach may have passed.

Some more rigorous souls would rely on the functioning of the price structure and flexible adjustments in prices to market forces as the proper means of stimulating buying for consumption and investment. In view of rigidities and upward thrusts in costs and prices characteristic of recent years, this last group tends to be skeptical about the possibility of reaching optimum utilization of resources under existing attitudes. They, however, look upon the price stability and the lower rate of wage increases of the past year as hopeful signs. Competition from abroad is increasingly serving as a damper on price and cost increases and particularly on the effectiveness of inflationary policies as a modus of stimulating expansion.

Under these conditions, the dangers for the immediate future seem to lie not in the threat of inflation but in the possible lack of motive forces for expansion at a pace that will bring about the optimum use of resources. The projected model should be considered as an expression of hope or an estimate of possibilities, not as a forecast or even as a plan for action.

Authorized for public release by the FOMC Secretariat on 3/17/2020

Role of Credit.

What are likely to be credit demands and needs in this type of situation? What would be the appropriate posture for monetary policy? Answers to these questions require first a review and appraisal of recent monetary policies and credit developments.

Federal Reserve policy during the past year has been directed toward two, somewhat conflicting, aims:

(1) Supplying reserves adequate to foster monetary expansion needed for economic recovery.

(2) Avoiding a decline in short-term interest rates so as not to encourage an outflow of gold.

What have been the results of these double-barrelled policies?

Recent credit expansion. - As to the first objective, total reserves at member banks have increased by close to a billion dollars, or over 5 per cent, in the past year. The manner by which these additional reserves have been supplied is not particularly relevant to the main story, but is of some interest for those concerned with Federal Reserve policy actions. Actually, the release of vault cash about a year ago supplied over $1,500 million -- or far more than enough to meet the increase in reserve needs. Over the year, however, this addition has been largely counterbalanced by substantial drains on reserves resulting from the gold outflow of about $800 million and an increase in money in circulation of about $400 million (excluding additions to member banks' vault cash holdings). Federal Reserve holdings of U. S. securities increased by close to $500 million. Although

Authorized for public release by the FOMC Secretariat on 3/17/2020

effort has been made to acquire longer-term securities, the net result of all operations and the approach to maturity of holdings has been a net increase in holdings of securities maturing in less than a year and a decrease in longer term issues as a group.

On balance, System action -- open market operations and release of vault cash -- supplied abundant reserves to offset gold and currency movements and to permit a substantial expansion in bank credit and deposits.

Total loans and investments of all commercial banks have increased in the past year by close to $15 billion, or nearly 8 per cent, and total deposits increased correspondingly. The difference between the 8 per cent increase in total bank credit and the 5 per cent increase in member bank reserves reflects a marked shift in deposit composition. Time deposits, with lower reserve requirements, increased by over $11 billion, or 14 per cent, while demand deposits adjusted increased by about $3.5 billion, or 3 per cent.

Nonbank holdings of other liquid assets also increased -- mostly in deposits at mutual savings banks and shares in savings associations. Nonbank holdings of Government securities showed little increase, notwithstanding a $5 billion increase in the public debt and a larger increase in the outstanding volume of issues maturing in less than a year. Nonbank holdings of all types of liquid assets have increased in the past year by about 6 per cent. This rate of growth in total liquid financial assets has slightly exceeded the 5 per cent expansion in Gross National Product and personal income, although the increase

Authorized for public release by the FOMC Secretariat on 3/17/2020

in the money supply, narrowly defined, has been at a slower rate -- about 3 per cent. The ratio of money supply to Gross National Product is about as low as it has been in over 30 years, and the ratio of total liquid assets to Gross National Product is also low, though it has remained relatively stable since 1956. Thus, it may be said that the increase in liquidity in the past year has been substantial, but by no means excessive for a period of economic recovery from recession. The current level of nonbank liquidity is low by historical standards.

Interest rates. - A distinctive characteristic of the past year's money and credit developments has been the course of interest rates, with respect both to level and structure. This has been in part, but not wholly, a reflection of monetary policies and in turn has been related to -- perhaps partly accountable for -- the unusual shift in the distribution of liquid assets. The striking facts are that interest rates -- both short and long -- declined much less in the recession of 1960 than in previous recessions and have not increased in 1961 as in the corresponding time-space of previous recoveries.

Policies followed by the Federal Reserve and also debt-management policies of the Treasury in 1961 helped to prevent short-term interest rates from declining by adding to the supply of short-term securities in the market, as well as by limiting additions to bank reserves. These policies were for the purpose of discouraging the flow of funds abroad and drains on our gold reserves. They have no doubt aided in the attainment of that objective. At the same time maintenance of short-term rates checked any decline in long-term rates. The sometimes purported aim of the misnamed "operation nudge", namely to lower long-term rates while holding up short rates, cannot be said to have been achieved.

Authorized for public release by the FOMC Secretariat on 3/17/2020

Other factors than official policies helped to hold up the general level of interest rates. The principal ones were the mildness of the recession, the large volume of new security issues by corporations and State and local governments in the first half of 1961, and the pick-up in Treasury borrowing. Anticipations were an important influence in preventing interest rates -- at least the long-term rates -- from declining as they did in 1958. The rather substantial flows of funds into long-term capital markets might reasonably be attributed in part to System and Treasury purchases of long-term securities in connection with "operation nudge". As Chairman Martin has pointed out, the purpose of the policy was to stimulate the flow of funds into investment, rather than merely to lower long-term interest rates. That purpose was evidently achieved.

One achievement or development that distinguished 1961 was the absence of the sharp speculative rise and subsequent fall in bond prices that characterized 1958. The avoidance of this speculative bubble was certainly a gain. At the same time, about the same amount of credit expansion was obtained in both periods. Perhaps these contrasting experiences contain a lesson as to the desirability, or rather lack of need, of aggressively easy monetary policies in recession periods. One of its more significant results is that rates did not rise in the recovery period, as they usually have. Interest rates are now about as high as might be expected at this stage of recovery.

As I have previously suggested, the maintenance of short-term interest rates at a higher level than usual for a recession period

Authorized for public release by the FOMC Secretariat on 3/17/2020

no doubt influenced the structure of the public's holdings of financial assets. Banks seemed to find it profitable to continue to pay relatively high rates on time deposits and to offer other inducements for such deposits. Oddly enough, most of the expansion in bank assets accompanying this increase in time deposits was in U.S. securities maturing in less than a year, on which the interest yields were below 3 per cent -- the rate paid on a large portion of the time deposits.

In any event, the public -- apparently both businesses and consumers -- decided to use funds obtained as a result of bank credit expansion to increase their holdings of time deposits, rather more than their demand deposits. As stated, only small increases occurred in nonbank holdings of Government securities. These developments again raise the old question as to the significance of the narrow definition of the money supply. It also throws some light upon the influence of interest rates on the composition of financial assets.

What about Future Credit Needs?

Formulation of monetary policy is usually more a matter of adapting to economic events - otherwise determined -- than one of determining the course of events. It might be said that during 1961 monetary policies in essence supplied all reserves needed to support the credit expansion that occurred. The banks were not flooded with excess reserves, because the result would have been a decline in interest rates that would in turn have induced an outflow of gold. Any redundant reserves would thus have been lost and not available. International interest rate relationships, along with domestic credit demands, determined our monetary policies. The net effect was that reserves have been made

Authorized for public release by the FOMC Secretariat on 3/17/2020

available to member banks at a 5 per cent annual rate of increase since last February. Public choice, influenced in part by interest rates, has largely determined the volume and composition of liquidity holdings and hence the amount of reserves needed and supplied. Although expansion in the money supply has been small, growth in the public's over-all liquidity has been commensurate with the recovery in economic activity, but not excessive.

Projections of trends in economic activity and incomes for the year ahead that would probably be possible without undue pressures on resources indicate, as previously pointed out, a further expansion in the order of magnitude of 7 to 10 per cent. Such an expansion in the economy would undoubtedly call for a commensurate, though perhaps not identical, increase in bank credit and in liquidity. Questions for Federal Reserve policy seem to be:

(1) How much bank credit and money will be needed to support the desirable rate of economic expansion?

(2) What proportion of the needed reserves should be supplied through open market operations?

(3) How much should banks be required to borrow?

(4) When should discount rates be raised?

In brief, at what time and to what extent should restraints on credit expansion be tightened or rather be permitted to tighten? It would be presumptious, as well as premature, to attempt definite answers to all these questions at this time. It may be useful, however, to suggest some of the factors that might be taken into consideration in endeavoring to reach answers as events unfold.

Authorized for public release by the FOMC Secretariat on 3/17/2020

As to the supply of money and bank credit that may be needed, the Board's staff has worked out an integrated model of financial flows that would be logically consistent with the type of economic expansion assumed in the mid-year budget review. This projected model includes a total volume of new funds raised in credit and equity markets of close to $60 billion in 1962. This total is somewhat below the record 1959 total in dollar amounts and still lower relative to GNP and relative to the rate of economic expansion that is projected. It is larger than the $48 billion estimated for 1961. Private credit demands would be somewhat larger than in 1959, and considerably greater than in 1961, while U.S. Government borrowing, with an assumed net increase of $7 billion, though a little larger than in 1961, would be much smaller than the peacetime record reached in 1959. Private short-term borrowing would presumably need to be much more than in 1961, but no larger than in 1959, while private long-term borrowing would be somewhat greater than in any previous year.

With respect to potential sources of these funds and also to the liquidity needs of the economy, it is assumed that there will be a moderate increase in the flow of funds through nonbank financial institutions, and also an increase in direct investment in financial assets by consumers and businesses. Flows of funds from this latter source, however, are not projected at anything like the record high level of 1959, when high interest attracted such funds into the purchase of securities. The needs for credit from the banking system would be about as much as in 1961 or around $15 billion -- plus or minus a billion or so, but much more than the modest $5 billion supplied by the banks in 1959.

Authorized for public release by the FOMC Secretariat on 3/17/2020

Resulting projections for money supply and total liquid assets are shown on the attached chart. They predicate an expansion of the money supply of about $6 billion or 4 per cent in the next year. Although this is a somewhat more rapid rate of increase than occurred in the past year and several times the small growth in 1959, it should be noted that, with a projected increase in GNP of 7 per cent or more, the result would be a continuation of the post-war downward trend in the ratio of money to GNP. That ratio is already at or below the low levels reached in the 1920's. One of the difficult questions to be faced in the future is how much further can that ratio decline without exerting a depressing influence on economic expansion.

Consideration needs to be given also to other liquid assets, which have increased so much more than money supply in the past year. A possible pattern consistent with the integrated model of economic activity and related financial flows is also shown on the chart. It calls for an expansion of about $18 billion -- or 7 per cent, compared with well over $20 billion in the past year and $17 billion in 1959. These estimates predicate that the growth in savings and loan shares continue at a $9 billion annual rate and that time and savings deposits at commercial banks will increase about $6 billion, with small amounts at mutual savings banks, in savings bonds, and in nonbank holdings of short-term Government securities. The projected total increase in all liquid assets of nearly $24 million, or 6 per cent, would result in a small decline in the liquid assets/GNP ratio, if GNP expands as projected.

It may be concluded that, in a situation of the kind projected,

Authorized for public release by the FOMC Secretariat on 3/17/2020

which assumes no excesses in terms of capacity, an expansion in the money supply of 4 per cent would not be excessive. If accompanied by an increase of 7 per cent in other liquid asset holdings of the public, it might be adequate. However, a more rapid expansion in demand deposits might be feasible without risk of excess and might even be needed to permit optimum performance of the economy.

To supply reserves and currency called for by the projected expansion in bank credit and the money supply, Federal Reserve credit of about $1.5 billion, plus any amount required to offset gold outflows, would be needed. The policy question to be determined in the course of the year will be what portion of the additional reserve needs should be supplied through open market operations and what portion should member banks be required to borrow. The answer to this question will depend on the vigor of credit demands and on whether any speculative or other unsustainable or unsound credit uses or practices emerge.

Since the expansion in credit and money projected in the models envisage some decline in the already low ratios of money and liquid assets to GNP, perhaps it would be appropriate to supply something close to the amounts projected by means of open market operations. Should demands for credit not exceed the amounts thus provided for, the general level of interest rates would presumably show little change. There might be changes within the structure of rates reflecting variations in demands in different sectors and in the public's use of its savings.

Should additional amounts of reserves be wanted to support more rapid credit expansion than that provided for, they would have to be acquired by banks through borrowing. Under such a program, credit

Authorized for public release by the FOMC Secretariat on 3/17/2020

restraints would tighten and interest rates rise, when, and only when, credit demands were in excess of the amounts indicated and were strong enough to induce banks to borrow to obtain the additional reserves needed. If these pressures mounted, at some stage discount rates would need to be raised. Presumably bill yields would first rise close to or above the level of the prevailing discount rate.

If credit demands should fall short of the projected needs, while reserves were supplied in the amounts indicated, then interest rates would tend to fall. Under those circumstances, policies might have to be adjusted to avoid an outflow of funds due to international differences in interest rates or to deterioration in public confidence as to the long-run value of the dollar. The international balance of payments situation and the level of interest rates abroad will probably continue to set a floor on interest rates and the degree of monetary ease that would be permissible in this country.

In conclusion, it should be emphasized that attainment of economic expansion in the period ahead at a pace and of a nature that are desirable and sustainable and the maintenance of our international payments position cannot be assured by monetary policy. It will depend much more upon nonmonetary forces than upon monetary policies. Monetary policies should aim to help, or at least not interfere with, the attainment of those broad objectives, and appropriate monetary policies are essential. Under existing conditions, monetary policy can be a passive factor, supplying reserves appropriate for an expanding economy, but no more than necessary to support the expansion that actually occurs.

Authorized for public release by the FOMC Secretariat on 3/17/2020

Variations in interest rates would be largely determined by the volume and vigor of aggregate credit demands -- public and private -- and by balance of payments considerations. To endeavor by monetary or fiscal policies to correct for structural defects or the mistaken actions of others could have harmful effects without correcting the basic difficulties.

Authorized for public release by the FOMC Secretariat on 3/17/2020