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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

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DEC 18 1962

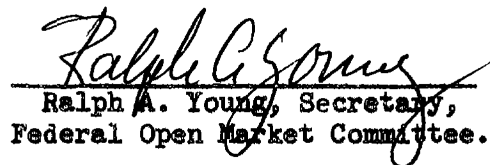
December 17, 1962.

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Young

For your information, there is attached a copy of a paper by the Secretariat of Working Party 3, Economic Policy Committee of the OECD, on "United States Monetary and Debt Management Policy," which the Secretariat circulated as a basis for discussion at the WP 3 meeting in Paris on December 12-13, 1962. Also attached is a copy of comments I made in answer to the Secretariat paper.



Ralph A. Young, Secretary,
Federal Open Market Committee.

Attachments 2

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ORGANISATION FOR ECONOMIC
CO-OPERATION AND DEVELOPMENT

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Paris, 29th November, 1962
CPE/WP3(62)37

Or. Engl.

WORKING PARTY NO.3 OF THE
ECONOMIC POLICY COMMITTEE

UNITED STATES MONETARY AND DEBT MANAGEMENT POLICY

(Note by the Secretariat)

1. To facilitate the discussion of the Working Party at its meeting in December, this note attempts to summarise:-

(a) The views on which the United States authorities have based their policies.

(b) The views which have led to certain European criticisms of those policies.

Section (c) puts forward, as a basis for discussion, certain conclusions which might be drawn from the exchange of views to date.

2. (a) U.S. Views. These can most conveniently be found in the remarks made recently by Mr. Roosa to the Mortgage Bankers Association of America, excerpts of which are annexed to the present note. According to Mr. Roosa, the United States authorities "placed the central focus of our [monetary and debt management] policies on encouraging and raising the level of private investment". In implementing this policy, the authorities refrained from any action that would put pressure on the long-term market; indeed the reverse: they sought ways of stimulating long-term investment flows, e.g. through Federal Reserve and Treasury purchases of long-term Government securities, and through measures to reduce the cost of mortgage financing. Concurrently, the authorities kept the economy, and particularly the banking system, adequately liquid to meet any possible domestic demand for business finance.

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3. It is clear from Mr. Roosa's remarks that the United States authorities were acutely aware of the problems posed by the need simultaneously to stimulate domestic investment and discourage increased capital outflows. In fact, the steady increase in the supply of outstanding Treasury bills was specifically designed to sustain short-term interest rates and thereby reduce any incentive for the export of interest-arbitrage funds. The pursuit of policies which contributed to the stability of long-term interest rates in the United States and the maintenance of liquidity in the economy reflected two beliefs:-

(i) that the balance-of-payments consequences of these policies were relatively small; because long-term capital movements are not very sensitive to relative interest levels; and because short-term interest rates can be used to limit substantially the outflow which the liquidity of the system tends to provoke;

(ii) that it was so important to maintain a financial climate which would encourage domestic investment that such adverse effects on the balance of payments as there were must be accepted.

4. (b) European Views. These seem to differ from those of the United States authorities on each of the above points:-

(i) the differential between United States and European long-term interest rates, together with the liquidity of the banking system, are thought materially to have contributed to the outflow of funds from the United States in spite of the policy pursued on short-term rates;

(ii) it is questioned whether monetary ease is likely to stimulate investment in the absence of other measures to stimulate demand.

5. (c) Conclusions. The Working Party may feel that some further discussion about the effect of monetary conditions on the United States balance of payments and domestic activity is necessary. But there may already be some basis for agreement about what should now be done. We suggest the following as a point of departure to see whether any such basis exists.

(i) the present combination of policies was decided on, in essence, nearly two years ago.

(ii) Subsequent events have altered the balance of considerations, so that the time is ripe for reconsideration of policy; reserves are continuing to fall and this means that external considerations should have greater weight; the gap between the actual level of activity and the potential is still significant.

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(iii) Some adjustment of United States policy has already been made, in the form of specific measures to stimulate investment. And more action is now proposed in the shape of tax reductions for 1963.

(iv) Monetary policy also needs to be changed.

6. In respect of point (iv) above, Mr. Heller's statement before the Joint Economic Committee, 8th August, is very relevant: "Any move towards a sizeable tax reduction must, of course, be accompanied by a willingness to move towards higher interest rates if this should prove to be necessary: (a) to discourage any adverse capital flows that might develop, or (b) to offset any inflationary pressures that might ensue if the rebound towards full employment should prove to be unexpectedly rapid."

7. Further discussion in the Working Party is needed before a conclusion on the nature and timing of such a change in monetary policy can be recorded. There would seem three broad alternative courses which could be taken with respect to timing:-

(a) the extreme course of tightening monetary conditions now, without waiting for the budgetary relaxation;

(b) the more moderate course of tightening monetary conditions concurrently with the proposed tax cut;

(c) the decision simply to allow the larger budget deficit, and subsequently the rising demand for funds that would accompany the expansion of activity, to have their natural effects on the money and capital markets.

None of these three courses would be consistent with action to prevent the increase in the budget deficit from having its monetary impact. The Secretariat feels it necessary to make this remark because, at the recent annual examination of the United States by the Economic and Development Review Committee, the United States representative suggested that such action might be found desirable next year.

8. With respect to the nature of any change in monetary policy, the Secretariat assumes that emphasis would be placed on reducing the rate at which reserves are provided to the banking system by the monetary authorities - accepting whatever consequences such action might entail in terms of reduced bank liquidity and higher levels of interest rates throughout the maturity range - rather than through any policy designed specifically to raise long-term rates.

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COMMENTS ON SECRETARIAT NOTE ON
U. S. MONETARY AND DEBT MANAGEMENT POLICY

1. A dominant purpose of monetary policy everywhere is to help avoid heavy domestic unemployment of labor and capital resources. There does not seem to be a difference between U. S. and European views on this score.

2. As a general principle, this purpose should be achieved with minimum unsettling effects on international payments flows. Under present conditions in the U. S., this means that it should be achieved in ways that do not conflict with efforts to reduce the U. S. payments deficit, and even more so in ways that do not tend to increase that deficit. Again, there does not seem to be a difference between U. S. and European views on this score.

3. In principle, efforts to reduce domestic unemployment can be made consistent with efforts to reduce a payments deficit, especially in a country where movements of investment funds play an important role in the balance of payments. Increased domestic activity not only tends to increase equity yields and thereby to make the country more attractive to domestic and foreign equity capital; it also tends to raise both short- and long-term interest rates and thereby to make the country more attractive to domestic and foreign capital seeking fixed-interest investment, including investment in both money and capital markets. It is hard to believe that there is any difference between U. S. and European economies on this point.

4. On the other hand, efforts to reduce unemployment may lead to a rise in U. S. imports that would mean a deterioration in the country's payments balance on current account. But if these efforts are accompanied by successful measures, including improved tax incentives to investment, that

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keep wages from rising more than productivity, the better utilization of existing productive capacity should lead to a decline in unit costs that will tend to improve the U. S. competitive position both for export and for import-competing industries and thus to offset, partly or even entirely, the rise in imports. There scarcely seems basis for difference between U. S. and European views on this point.

5. There can thus be difference of views on only two aspects of possible actions in the field of monetary policy: (a) whether efforts to reduce unemployment should include still easier monetary policy; and (b) if they should not, whether efforts in other fields, notably the fiscal field, should be accompanied by a tighter monetary policy.

6. There is no difference between European and U. S. views on point (a). On neither side of the Atlantic is a further marked easing of U. S. monetary policy being widely urged. This is as true for policy measures that might contribute to lower long-term rates as for those that might foster increased bank liquidity and lower short-term rates.

7. There is little difference in principle on point (b). On both sides of the Atlantic, it is recognized that expansionary non-monetary policy action should not be permitted to generate inflationary pressures on costs and prices or to stimulate unduly the outflow of short- and long-term capital. The only difference can concern (i) the degree of offsetting restraint necessary to avoid such adverse repercussions, and (ii) the ways in which such restraint should be accomplished.

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8. Here again the differences can be further narrowed. There is no difference about the desirability of avoiding short-term rates that would stimulate volatile movements of short-term funds between international money markets insofar as debt management and monetary operations can do this without impairing other objectives. Actually, U. S. policy has been remarkably successful in this field. Until recently, the outflow of short-term funds had been reduced to relatively small dimensions and a recrudescence in the fourth quarter, largely connected with both developments in Canada and the Cuban crisis, was rapidly brought under control.

9. As to long-term funds, some European observers, in our judgment, consistently exaggerate the role of interest-rate differentials. Foreigners borrow in the United States in large part because the U. S. capital market is the only one that is completely free of controls, and apart from the London market the only one that can accommodate large flotations without trouble and at low underwriting or issue cost.

10. It is true that foreign long-term borrowings in the U. S. market this year will probably reach a total of $1 billion. A large part of this total is represented by the heavy volume of Canadian issues floated in the second half of the year. This long-term borrowing can be curtailed only by means that would similarly curtail domestic long-term borrowing as the Canadian and U. S. capital markets are so closely intertwined that U. S. monetary authorities could not hope to create by their own actions an interest-rate differential between the U. S. and Canada that would choke off the underwriting of Canadian issues without also choking off some volume of domestic flotations.

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11. Capital issues of non-Canadian foreigners in U. S. markets are consistently taking place at rates significantly higher than those for domestic or Canadian flotations. Experience has shown that interest rates on these issues vary much less than do interest rates on comparable domestic issues. Thus, if domestic interest rates could be raised by as much as, say, one percentage point, interest rates on non-Canadian foreign issues would tend to rise only by a fraction of one point. This means that moderate increases in rates could not be expected to have much effect on the over-all costs of foreign offerings in U. S. markets and conversely that any increase in rates that would have significant effect on foreign offerings would have an even greater effect on the volume of domestic flotations. It is worth recalling that many investors who would be expected to respond to changes in long-term rates--public utilities, public transport, residential construction--are isolated from market factors in many European countries by government ownership or some sort of government licensing or other controls. Under such circumstances the influence of long-term interest rates on investment decisions might be expected to be substantially less than in the U. S. economy where such direct government influences are largely absent.

12. Under existing conditions and obstacles to international borrowing in foreign markets, the relative interest inelasticity of foreign security offerings in the U. S. is illustrated by the experience that identical foreign borrowers, corporate and governmental, have borrowed in the U. S. at higher rates than in other financial markets. This suggests that foreign issues in U. S. markets could be significantly affected only if rates in the U. S. were permitted to rise well above rates in other leading foreign markets.

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13. In view of the relatively high rate of monetary savings in the U. S. and the relatively low rate of demand for investment funds, which both reflects and is a main reason for the present level of unemployment, any attempt of the monetary authorities to force long-term rates in the U. S. significantly above those in other leading countries would not only fly in the face of market forces but would also cripple any attempt at reducing unemployment by non-monetary means.

14. To summarize, then, the only feasible way for monetary policy in the U. S. to proceed in promoting domestic objectives without having an unduly adverse effect on the U. S. payments deficit is thus: (1) to continue to keep short-term rates at levels that limit outflows of volatile funds; (2) to avoid a further significant increase in bank liquidity at a time of rising domestic demand for bank loans so as to curb any spill-over of bank lending capability into meeting foreign demands; and (3) to permit long-term rates to rise, not by resorting to deflationary monetary action, but as the result of monetary action designed to keep money and capital markets orderly and well functioning, so that they naturally respond to such rise in demand for investment funds as may be expected to follow expansionary fiscal policy.

15. Non-inflationary rather than deflationary monetary policy will be particularly appropriate in case of a significant increase in the U. S. Government deficit from tax reduction in fiscal 1964, as such a deficit would give rise to increased Treasury demand for loanable funds. If there were to be little or no bank credit expansion and the Government's demand for credit were to absorb a total of loanable funds equal to the supply made available by tax reduction, the fiscal policies giving rise to the deficit would tend to have little net expansionary effect.

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16. The Secretariat paper contends that the present combination of financial policies in the U. S. was decided on, in essence, two years ago. Actually, as we have tried to emphasize in our various presentations in this Working Party, the U. S. debt management and monetary policies are never "made" in the sense that the Secretariat paper would seem to assume. They are continuously reviewed and discussed, and their technical interactions appraised. What appears as policy retrospectively is the product of a stream of policy decisions made each week in the light of the financial problems confronting the authorities. So long as the problems continue to be of a particular character, existing policies will be continued. In this sense, present policies were made last week--not two years ago. Both debt management policy and monetary policy have unique qualities of administrative flexibility, a characteristic that distinguishes them in the U. S. from fiscal policy. If the problems which they respectively confront change, they can be expected to adapt in the light of the changed circumstances. But it is not possible to predict their individual adaptation, except to say that such adaptation would be within a general framework of operational principles appropriate to their specific role and function.

17. Finally, the appropriateness of any nation's monetary and fiscal policies must be related, first and foremost, to the fundamental strength and tendency of its economy. The salient facts on the fundamental U. S. position are as follows:

(1) U. S. economic activity, while high, leaves substantial portions of resources unemployed.

(2) The U. S. economy shows no signs of inflationary pressure.

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(3) By historical standards, the U. S. trade surplus with respect to the rest of the world is high, absolutely and relative to the stage of the cycle.

(4) The improving relationship of U. S. costs to foreign costs suggests further gradual strengthening of the international competitive position of the U. S. as an exporter.

These fundamental facts call at present for a moderately stimulative monetary policy supplemented in the near-term future by a more expansive fiscal policy in the form of a tax cut. Such a policy is particularly appropriate in the present circumstances when improving business sentiment may make the economy especially responsive to ample credit availability. And it needs to be remembered that the U. S. economy has for many months been delicately balanced, with important elements of business opinion inclining to the view that the economy's next move would be down. U. S. monetary policy, we believe, has operated to help avoid this outcome and to foster a financial climate favorable to resumed expansion.