

Moreover, the Federal Reserve is able to have a relatively direct effect upon the total of credit used. Part of this effect is through the influence the Fed is able to have upon interest rates.

Interest rates probably are not as effective a rationing device as are prices in other markets, but interest rates do unquestionably have some influence on decisions as to whether or not credit should be used.

A more important effect of Federal Reserve policy upon total credit growth is upon the ability and willingness of commercial banks to lend. Through regulation of bank reserves, the Federal Reserve has considerable power to control the availability of funds to banks, and thereby, the availability of bank credit.

In our complex credit markets, there is considerable latitude for borrowers to shift to commercial paper or other media when bank credit is not available, as happened in 1966, so that regulation of the ability of banks to lend does not provide precise regulation of total credit actually used. But the very process of forcing credit flows through other channels does create frictions that have a limiting effect upon credit used and upon credit-supported economic activity.

Interest rate changes probably should be viewed as the consequence of the effort to regulate credit flows rather than as a target in setting guidelines for policy. Given responsible fiscal and monetary policies, it is unlikely that the private economy would generate changes in the demand for credit that would cause interest rates to fluctuate widely. There would be justification, however, in establishing guidelines for Federal Reserve policy in maintaining a viable relationship between interest rates in the United States and in the international money market.

One of the most promising developments of the past decade has been the emergence of a truly international money market and, more recently, of an international bond market. It will be impossible in the future for any industrialized nation, including the United States, to pursue autonomous credit and monetary policies that do not take account of this market.

Once it is possible to remove the present restraints on international credit flows, interest rates in our market will be closely tied to and influenced by interest rates in the international money market. The operation of market forces will tend to maintain interest rate structures here and abroad in line with one another, with the necessary allowance for the cost of hedging the investment.

In executing domestic monetary policy in this setting of a broad and fluid international money market, the Federal Reserve from one time to the next will wish to move our interest rate structure marginally above or marginally below interest rates abroad, depending upon the economic circumstances at the time.

For example, at a time of relatively slow economic growth in our economy, Federal Reserve policy aimed at promoting credit availability would lead to interest rates in this country moving somewhat below interest rates abroad. At such a time, the U.S. trade balance should be relatively strong so that the outflow of short-term funds induced by this interest rate differential would be appropriate.

At times of unduly rapid and inflationary growth in this country, Federal Reserve efforts to limit credit availability would lead to higher interest rates here than abroad, inducing a flow of funds into the U.S.