BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

OFFICE OF THE CHAIRMAN

The Honorable Paul H. Douglas,
United States Senate,
Washington 25, D. C.

Dear Senator Douglas:

Thank you for your letter of November 5, expressing your appreciation for the Board's contribution to your Committee's study of Employment, Growth, and Price Levels.

For our part, we have been most impressed with the fine work that your Committee and its staff have been doing in bringing together the thinking of qualified persons, in formulating questions to be addressed to us and to other agencies, and in the studies thus far published.

In reading over the material that has been presented to your Committee, it occurs to me that there are two aspects of the problems under study that may deserve more explicit consideration than has been given to them so far. For this reason, I am taking the liberty of bringing them to your attention in this letter.

The first point that I have in mind relates to imperfections in our price system--variously referred to as cost-pushes, ratchet effects and administered prices--and perhaps it can best be phrased in the form of a question. Granting that there are these imperfections as regards the behavior of individual prices and that they create inflationary pressures or biases in economic processes that cannot be effectively dealt with by monetary policy, does it follow from this that monetary policy should be less (or more) restrictive than if such phenomena did not exist? I am sure that all serious students of economic policy are concerned with this question, and to some extent, their views are implied in their responses to other questions. I know this is true, for example, in the case of much of the material which the Federal Reserve has furnished to your Committee.

As I understand it, the argument presented by those who advocate acceptance of creeping inflation is that institutional factors which are not dealt with directly by Government action

are likely to cause money wages and administered money prices in certain basic industries, to increase more rapidly than is consistent with full employment of the labor force and the growth of other productive resources. Therefore, unless these wages and prices are, in effect, reduced by inflating the price of everything else, we will suffer from chronic underemployment. In other words, these advocates suggest that monetary and, indeed, fiscal policy as well, should be used openly to frustrate the bargaining efforts of organized labor and the pricing policies of certain industries. Only in this way, they imply, can a workable equilibrium be achieved between the marginal productivity of labor and real wages and between the relative prices of competitively marketed and administered price goods.

The objections to a policy of deliberately engineered creeping inflation seem to me to be manifold. I hope the problems generated by such a policy, with respect to the whole process of saving and investment and for the balance of payments, have been adequately treated in my responses, and those of others, to the questions asked by your Committee. If this is the case, all that needs to be said here is that these problems would be greatly intensified by any effort to absorb wage increases and administered prices through calculated inflation.

Beyond this, I think there is a very serious question as to whether such a policy could possibly succeed in the accomplishment of its primary objective. Would those who are in a position to administer prices or extract wage settlements in excess of productivity gains be content to maintain the same pace when they discovered that their efforts to capture a larger share of the real income stream were being frustrated by calculated inflation? Would they not increase their demands further to improve their relative position?

Thus, it seems probable that, far from encouraging a high level of employment and growth in the economy, a policy of calculated creeping inflation would not make any contribution--and certainly not a lasting one--toward the correction of the difficulties toward which it was directed. On the contrary, it would involve all of the social injustices that economists universally agree accompany inflation, and it would also disrupt the saving and investment process, which must function efficiently if vigorous growth and high level employment are to be sustained.

If we reject a policy of deliberate inflation, what should be the role of monetary policy in a situation in which the

over-all price level or average of prices is being pushed up by administered costs and prices? Increases in the general level of prices, and the expectation of further increases, regardless of their origin, diminish the incentive to save and increase the incentive to borrow. Hence, unless credit expansion is limited to a rate of growth consonant with the increase in the physical output of goods and services a cost-push inflation will automatically become a demand-pull inflation as well. This point is spelled out in one of the papers I referred to in my replies to your Committee, but I would like to quote it in this context.

"It is the fact of rising prices or anticipation of rising prices that provides the incentive to borrow to finance overaccumulation of inventories and the construction of plant capacity in advance of need. It is the fact of rising prices or the anticipation of rising prices that leads to misallocations of investment and miscalculation of investment decisions. It is rising prices or the anticipation of rising prices that diverts savings into equities, and that dissipates their ability to finance growth, in short, that diminishes the supply of loanable funds and accentuates the demand in such a way as to force high and rising interest rates. Finally, it is the fact that a country's prices have risen above those of its competitors that prices a country out of world markets and initiates a deficit in the balance of payments. All of these reactions, which place great strains on the monetary and fiscal mechanism, ensue irrespective of whether an inflation may be described as cost-push or demand-pull.

"In the credit market, these situations increase the profitability of operating on borrowed funds even at very high interest costs. They increase, therefore, the demand for borrowed funds far above the amounts made available by savings and unless they are resisted by appropriate fiscal and monetary policies, i.e., by balanced budgets and by restraints on the availability of reserves, they result inevitably in an expansion of bank-created money.

"Because borrowing to anticipate inflation appears very profitable, the pressure of customers on their banks to borrow is very heavy and this in turn brings pressure on the Federal Reserve Banks to expand reserves. If this pressure is resisted, interest rates may have to rise quite sharply before the force toward overexpansion is contained. If the pressure is not contained and bank-created money is used to finance these hedges against inflation, the inflation, even if it started as a cost-push type, will by that very fact be converted into one of the demand-pull variety."

This indicates how the pressure of cost-pushes on price levels leads to conditions in which monetary policy tends to be forced into a more restrictive position than would otherwise be the case and the level of interest rates tends to be higher than would otherwise be required to maintain the balance between savings and investment. On the one hand, it gives strong support to the desirability of direct and vigorous attack on cost-push elements themselves. On the other hand, it suggests to me that the adoption of a "stable plus cost-push" goal for prices could not lead to anything but trouble. It would both encourage the proliferation of cost-pushes and, at the same time, provide the demand-pull to match them. We come back to what appears to me the inescapable conclusion that deviation from the objective of reasonable price stability for all arms of public economic policy would multiply our difficulties, not reduce them.

The second, and related question which I think deserves more examination and probing, might be stated as follows: Does the demand for credit from consumers and for private investment sometimes converge on the market with such vigor that it defies any reasonable application of general monetary and fiscal measures, producing either uncontainable inflationary forces or the impoverishment of certain socially desirable programs which are unable to compete for loanable funds, and perhaps having both effects? If this happens, should an attempt be made to expand bank credit sufficiently to satisfy all creditworthy borrowers at a lower rate of interest than the demand and supply relationship between real savings and investment would establish? This sort of a surge in the demand for credit in the private sector, it is argued, presents a problem not unlike that to be faced should the Federal Government be required to expand its expenditures and borrowing rapidly in a defense emergency. The implication is that bank credit expansion--a form of forced saving through inflation--is the only way to meet this problem so as to prevent socially undesirable distortions in the economic system.

To me, this line of reasoning is indefensible, on both moral and economic grounds. To the extent that such a program could succeed, even temporarily, it could do so only because the public was deceived as to the nature of the policy and its effects. The moral objection to any national policy based on public deception seems to me overwhelming. On economic grounds, this kind of monetary policy could not possibly succeed for more than a very short period. Even before the economic effects became fully apparent, they would be anticipated by those who would seek to protect themselves from the ravages of inflation, or to profit from it. The inevitable result would be a rapid decline in the volume of savings and an even more rapid rise in the rate of interest than would otherwise have occurred.

Rather than inflation, the first approach to a solution to this problem lies in a sound general monetary and fiscal policy. Of equal importance is the elimination of those imperfections in the operation of the price and wage mechanism mentioned in connection with my first point. If we do these things I believe there is a strong likelihood that we will avoid the kind of surges of credit demand that are postulated. If they still occur then we should certainly consider the application of selective controls on credit use by consumers and businesses. I would like to hope that these can be avoided because I am sure that they are bound to interfere with the process by which resources are directed to their most efficient uses in a free enterprise economy. When one weighs the alternatives, it seems clear that such controls would be preferable to either calculated or uncontrolled inflation, but we should recognize that they involve a degree of regimentation never before accepted in this country except in time of war.

I have addressed myself to these questions at some length because I think there may have been some real misunderstanding of my position. My interest in a monetary policy directed toward a dollar of stable value is not based on the feeling that price stability is a more important national objective than either maximum sustainable growth or a high level of employment, but rather on the reasoned conclusion that the objective of price stability is an essential prerequisite to their achievement.

I want to emphasize that I am most concerned with the preservation of freely competitive markets and the correction of any institutional imperfections which exist in the working of the price mechanism. While such imperfections cannot be corrected simply by a sound monetary and fiscal policy; they surely cannot be corrected by an unsound financial policy.

Nor does a sound general monetary policy necessarily, in itself, accomplish the optimum distribution of loanable funds among various sectors of the economy. It is not only the right but the duty of Government to assure that socially necessary programs are adequately financed. But, again, this objective can never be well served by unsound general monetary or fiscal policies. If, as a matter of public policy, the financing of school construction, for example, should have an over-riding priority in the allocation of resources, this can be accomplished in a number of ways, but we can be sure that it would not be accomplished by the general expansion of bank credit and money.

I trust that these additional comments will be helpful to your Committee in its work of clarifying for the Congress and

the nation the basic issues involved in attaining and maintaining optimum levels of employment and vigorous growth, as well as a structure and level of prices conducive to both.

Sincerely yours,

(Signed) Wm. McC. Martin, Jr.

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