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PROSPERITY, POLICY, AND PRUDENCE

Address of C. Canby Balderston,

Vice Chairman, Board of Governors of the Federal Reserve System,

Before the Annual Meeting of the
National Bank Division, American Bankers Association,

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The momentum of recovery has been carrying business upward to record highs that are to be anticipated when a growing economy is booming. Now that prosperity is here it should be enjoyed but not abused. And so, it may be timely to ask what bearing the current advance may have upon future business prospects. For instance, is the rate of expansion inducing speculative giddiness among businessmen and consumers? Can the present pace be maintained and the period of prosperity be extended?

Although fluctuations are inherent in the nature of business, their amplitude may be subject to human control. One of the most significant of the available control devices is general, flexible, monetary regulation. My task is to explore its role as an antidote to business recession, and as a restraint upon inflation.

Since the recession of 1953 has now disappeared both here and abroad, it is worth while to examine the evidence as to the effectiveness of monetary policy in restoring prosperity. It is important to discover whether the skepticism is justified that easing credit to solve depressions is no more effective than "pushing on the end of a string". In the U. S., a policy of active ease was followed by the Federal Reserve in the second half of 1953 and throughout most of 1954. Credit was readily available to meet the demand for sound loans. The availability of credit enabled liquidation to proceed in an orderly fashion. It has fostered subsequent expansion. The money supply increased mildly during the recession and sharply in the early stages of expansion. Monetary policy appears to have played an important role even though other factors contributed to the mildness of the recession and the prompt reappearance of recovery.

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Our experience is in line with the results of similar monetary policies followed in the United Kingdom and in Continental Western Europe during the slight recession that followed the post-Korean boom. In most of these countries, the transition from overexpansion to stability was accompanied by a slight drop in output and employment. However, a new upward movement soon developed, and by the spring of 1955 industrial production nearly everywhere reached record levels: in the United Kingdom, about one-fifth, and in some Continental European countries, such as Germany, as much as one-third higher than in 1952.

The effectiveness of increasing the supply and availability of credit to convert a business decline into recovery seems to turn on the presence of four factors: (1) An inherently sound business structure, unweakened by excessive speculation. (2) Business confidence that additional credit can be put to constructive use. (3) The existence of potential borrowers with sound credit standing. Their credit-worthiness reflects the extent to which equities have been maintained. (4) Fiscal actions favoring recovery, such as automatic tax reductions.

In short, monetary policy in itself cannot restore prosperity under all circumstances; but in a propitious climate like that of 1954 it can provide important aid.

This brings us to another question concerning the role of monetary policy that is of current significance both in Europe and in this country: can general credit control restrain the speculative ebullience that causes recoveries to become bubbles or blisters and then to burst? If it is to succeed, what teammates does it need?

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In recent months, financial stability has become endangered again in the United Kingdom and in some parts of Continental Europe, such as Scandinavia. These difficulties cannot be compared in magnitude with the inflationary pressures that made themselves felt in the early postwar years or during the Korean war; however, they have been serious enough to induce the countries involved to take quite drastic steps.

The recent British experience is particularly interesting. The United Kingdom twice raised its discount rate this year; moreover, it adopted measures to curb instalment credit and recently the Chancellor appealed to the commercial banks to reduce their advances. This tool of "moral suasion" is the more effective in the United Kingdom because its banking system consists of such a small number of large institutions. However, just when stability seemed about to be regained, the British transportation system was disrupted by railroad and dock strikes with adverse repercussions on British external accounts.

The current situation in our own country, too, provides a severe testing for monetary policy. Now that business is prosperous and constantly making new records, the problem is to maintain prosperity by restraining unwise speculation.

Although monetary policy standing alone is not sufficiently potent to maintain stability, the strength and resilience of the American financial structure to withstand shocks, whether inflationary or deflationary, centers around it. Its main purpose is to help provide enough credit and currency to foster a high utilization of the nation's physical resources, technical skills and manpower without inducing inflation. Maintenance of the appropriate amount

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of credit and currency at a given time for given conditions is at the heart of the central banking problem. It is the supreme task of the Federal Reserve. In more concrete terms, the credit and monetary authorities must furnish the reserves needed by the commercial banks to finance the economy at a high level of resource utilization without contributing either to inflation or deflation. The cost and availability of credit must guide the savings of the economy into constructive activities; the quantity of credit must reflect a rate of growth in the active money supply that is in keeping with the habits of the population in maintaining cash balances and with the growth in available resources. The problem of insuring growth without inflation involves a correct appraisal of the future rate of expansion that the economy can sustain. This appraisal needs to be made with as much precision as prophecy of future happenings will permit.

In order to be in a position to make the maximum contribution to stable economic growth, the Federal Reserve finds it necessary to keep informed on developments in all segments of the economy. This involves gathering and analyzing current data on credit, production, and prices. It also involves keeping alert to longer-range structural developments in banking and in the economy generally. That is a major reason why the Federal Reserve is conducting a business loan survey this year. Through increased knowledge of the lending practices of banks, small as well as large, and the types of customers served, the Federal Reserve will be in a better position to judge the impact of future economic developments on the credit and monetary system.

In curbing inflationary developments, appropriate fiscal and debt management policy is important. It includes, at all levels of government, budgeting that diminishes or eliminates deficits. It includes, in addition,

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debt management that is contrived to mop up funds that would otherwise go into ill-considered expansion, while at the same time maintaining sufficient liquidity.

Another essential adjunct to general monetary controls in restraining speculative ebullience is attention by borrower and lender alike to the quality of credit. If a parody of Shakespeare be permitted, it is important that the quality of credit be not strained. To keep excessive optimism in leash requires prudent judgment, and is the overriding obligation, not only of business executives and of labor leaders, but of bankers in particular for bankers have unusual opportunities to secure an overall view of the economic scene and they possess exceptional experience and skill in dealing with risks.

In past generations, many forward movements that appeared to be solidly based were injured or destroyed by lack of sufficient caution and judgment to curb overexpansion and overborrowing. Many of the great financial crises which have become part of our business tradition were the unhappy result of speculative excesses and a too exuberant granting and use of credit. It is superfluous to cite the historic cases of the bulbs of Holland, or the Mississippi bubble, or the railroad boom that preceded 1893, because many of you have personal recollections of more recent crises. There was the Florida land boom ending in 1926, and the overborrowing abroad that spoiled our foreign lending between the two world wars, even though sound arrangements had been worked out initially between responsible governments and responsible banking houses. There was the stock market boom that was ballooned skyward by billions of dollars of credit until its sudden return to earth after October 1929. There were the difficulties encountered by the plan to merchandise mortgages during the 1920's. This last example illustrates how a scheme calculated to meet a definite need (and which

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would have contributed to the financial advancement of its time) was spoiled by a too-liberal appraisal of real estate values, and by the lack of appropriate amortization.

Now I come to my principal concern: the quality of business decisions is important at all times, but especially so during prosperity. In short, the duration of the current expansion will be influenced by the quality of policy decisions now being made by business executives. I do not mean only the business decisions made by marginal concerns, but also those by business leaders who are the banks' most valued customers. Unless their decisions reflect an objective appraisal of present and future trends, such credit as proves later to have been unwise will embarrass the bank and plague the borrower. What I am urging is that executives should risk neither too little nor too much; be willing to venture but still guard against unwarranted optimism. The problem, of course, is how to balance protection and risk; caution and daring; conserving and expanding; the safety of a strong cash position and the growth that borrowing makes possible. Even during this delectable prosperity, bankers and borrowers alike may be wise to watch cash position. To maintain its strength diminishes immediate earnings perhaps, but so does insurance of any kind. An appropriately liquid condition provides a buffer for the shocks of bad times; protection against bad luck or miscalculation. The time to fix the roof is when the sun is shining.

My overall conclusion as to the ability of general monetary policy to restrain inflation is that it is our best hope, but that it requires the collaboration both of fiscal policy and of such executive prudence as will maintain the quality of credit.

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This conclusion may appear to beg the question unless the meaning of credit quality is made more concrete. Obviously, there is no formula by which a good risk may be differentiated from a poor one. Therein lies the art of extending credit. But some of my present concern may be reflected in the form of questions.

1. Is credit being sought and extended for purposes that are primarily speculative rather than constructive? Is making a "fast buck" the objective rather than increasing the supply of goods and services?

2. How long does it take the owner to obtain a significant equity in durable goods that are bought on time, in view of the rapid early depreciation of the goods and the costs of financing their purchase? If the terms of automobile paper are 1/3 down and 30 months to pay, the owner's equity at the end of one year is about 30 per cent of the depreciated value of the automobile and somewhat more than 15 per cent of the original value. If the terms are 1/4 down and 36 months to pay, the owner's equity at the end of a year is only about 10 per cent of the depreciated value, and not much more than 5 per cent of the original value. Suppose the borrower loses his job, or his sense of responsibility toward his obligations, especially if a price decline causes him to feel that he has no equity left and that he is "paying for a dead horse"!

3. Is adequate liquidity being maintained by banks as well as by their borrowers?

4. Are future growth, prosperity, and equity values being overly discounted?

5. Are construction costs being raised unduly by too intensive activity in this segment of the economy?

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It is probably not fruitful to attempt generalized answers to these questions. More important by far will be the answers reached by each banker and his customers as they make individual decisions. They alone are in a position to estimate accurately in advance whether a particular action seems prudent and sound. They, too, must await actual experience for confirmation, but if one observes the pageant of history, do not some guides appear that help to avoid blunders leading to future losses? Some one has said that hindsight should lead to insight and insight to foresight. Perhaps regret may be avoided if business executives ask themselves certain searching questions now before overexposure to the delightful warmth of prosperity leads to blisters.

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