INFLATION, GROWTH, AND TRUSTEE DECISIONS

(Remarks of C. Canby Balderston, Vice Chairman, Board of Governors of the Federal Reserve System, before the New England Trust Conference, Boston, Mass. on December 13, 1957.)

Balderston, C. Canby
12/13/57

Between the 'thirties and the 'fifties, the need for savings and the uses of them have altered drastically. In 1934, the rest of the world sent to this country nearly $300 million of its savings. In 1956, we sent them about $3 billion of our savings, chiefly in the form of direct investments, issuance of foreign securities in the American market, and bank credit.

In the 1930's, savings were in excess in this country. Refugee gold was pouring in to escape the threat of Hitler's persecution and of the war that was building up on the horizon. But our nation had forgotten for the moment how to use savings constructively. Those were the days when the supposed maturity of the economy was part of our intellectual coin, and when entrepreneurs lacked the initiative and the daring to expand plant and otherwise to venture. The climate was one of pessimism that approached despair, prompted perhaps by the loss of equities from stock market and inventory setbacks, and the sacrifice of homes and farms. Men's minds were tortured by anguished recollections of what they might have salvaged had they had more foresight and greater liquidity; they were in no mood to embark on new enterprises or to manufacture new lines of products.

How urgent was the situation was reflected in the measures taken to revive hope, and to stimulate the assumption of debt for acquiring homes, autos, and other durables. It was in 1934 that FHA came into being with its Title I to induce bankers to make instalment loans for the rehabilitation of existing homes, and Title II to encourage the flow of savings into the acquisition of new homes. The necessary down payment for a house was more than halved to the requirement of only 20 per cent. For the remaining 80 per cent, the mortgage terms

Copy filed.
500.

were lengthened to 20 years and the insuring of mortgages was intended to make them attractive to investing institutions.

Compare the complete about-face in the present desire for savings here and abroad. Population growth is now 1.8 per cent a year as compared with less than 1 per cent in the 1930's. The children already born will, by 1965, increase the number of teen-agers by 48 per cent over that of 10 years before. Such growth gives a strong sustaining impulse to the economy, because of the expanded need for homes, schools, roads, hospitals, plant and equipment and all the other physical facilities demanded for a good life.

Then, technical advance has been accelerating. It has increased to awesome proportions man's ability to destroy himself, but it also has enhanced his ability to achieve a satisfactory material existence. Though critics may observe that this is too much an age of gadgets, technology has increased the chances of millions to enjoy the comforts once reserved to kings. The evidences of this great advance surround us in our homes and on the roads. Visitors from abroad are struck by the enormous parking lots with which factories have had to surround themselves in order to accommodate the cars in which their employees drive to work. Whether the car takes from the employee a disproportionate share of his disposable income is a separate question, but it is certain that electrical refrigeration has displaced the icebox, the iceman and the once familiar stories about him. The rapidity of change has made obsolescence a pervasive phenomenon and the price—the welcome price—of technical advance.

This is placed in perspective if we use the dramatic language of Dr. Robert E. Wilson, Chairman of Standard of Indiana. "Let us compress the supposed 500,000 years of man's development into 50 years. On this time scale, it took man 49 years to get over being a nomad--even longer to get his first pair of pants. . .

"A few months ago, a few men learned to write; two weeks ago the first printing press was built. Only within the last 3 or 4 days have we really understood how to use electricity. . ."

The basic question that has been facing our nation is how to provide for continuing and healthy growth without inflation. Obviously, the expansion of credit and currency should be adequate to sustain economic growth. It is equally obvious that excessive and unsound credit expansion can thwart progress. The problem of insuring growth without inflation involves a correct appraisal of the future rate of expansion that the economy can sustain. Concretely, it means directing monetary policy toward furnishing the reserves needed by the commercial banks if they are to finance the economy at a high level of resource utilization without contributing either to inflation or deflation; it means promoting financial arrangements that will direct the economy's savings into activities that are constructive; it means increasing stability and diminishing instability.

It is my conviction that the two objectives of monetary and fiscal policy--economic growth and monetary stability--are inseparably linked. In the long run they stand or fall together. To me, the orderly, sustainable growth of our economy, and the provision of the savings necessary to it, are most unlikely unless the purchasing power of the dollar is kept stable. Rising prices, in general, lead to less care in the allocation of capital and other resources.

If the purchasing power of the dollar declines persistently, the incentive to save is undermined, as stressed already, and business executives in their decision-making tend to substitute speculation for the goal of long-run efficiency. Instead of making decisions prudently in the light of well-founded expectations as to market demand, productive capacity, inventory needs, and changes in productive efficiency, businessmen are tempted to speculate on steadily rising costs and values, gambling upon being able to pass on, in price increases, the additional costs of forward commitments. The end result of such decisions is the misallocation of resources. Out of such imprudence come the unsustainable booms and crises that have punctuated our industrial history.

To achieve these dual objectives of growth and stability, the nation needs to maintain a proper balance. At a particular moment it may have too little plant to fill consumer demand, or conversely may have excess capacity that depresses prices and business. The long-run health of the economy turns on striking a balance among the countervailing and changing forces--business and consumer, private and government. It depends also on how well fiscal and monetary policies are attuned to the needs of a flexible economy, in which some sectors are readjusting while others continue to sustain growth.

The experience of the past few years sheds some light on problems involved in maintaining economic growth and stable prices during a period, first of rapid cyclical recovery, and then of high rates of resource utilization. The early part of the period was characterized by price stability; thereafter, the general price level rose persistently. During the period 1954 to 1957, the gross national product in current prices--the measure of the nation's output of goods and services valued at prevailing prices--rose by about 20 per cent. In contrast, the rise of gross national product in constant prices, i.e., the value of output after allowing for price rises or declines, rose by only 11 per cent.

Although it is not safe to draw too firm conclusions from short-run economic movements, this much might be said of the past three years. We achieved our most rapid growth during the period of relative price stability. Subsequently, the rate of growth fell sharply. Thus, the argument that creeping inflation would stimulate the rate of growth in real output has not been substantiated by recent experience. The further rise in prices proved to be functionless.

Economic progress that is balanced

It is my purpose to examine in somewhat more detail what economic progress means. I have defined its goal as follows: to foster orderly economic growth and to sustain employment at consistently high levels. In still shorter words, it is to provide more jobs and more goods combined with a dollar of stable buying power, which implies that there can be no economic equilibrium unless the dollar is stable. The key words here are "orderly", "sustain", and "consistently". It is important to have as high a rate of growth as the economy is willing and able to maintain steadily, but there is no rate that the Federal Reserve is attempting to impose on the economy, nor could Federal Reserve policies by themselves assure the attainment of a fixed rate of growth.

The swings are accentuated by imprudent decisions. A management that expands merely to keep up with the competitive Joneses, without careful market analysis, or provision of the necessary financing, is a contributor to unbalancing credit demand. So is a company that uses up its normal working capital, whether to pay dividends or to build up inventories or to postpone going to the capital markets, and then finds itself without funds to pay taxes.

The problem is to secure balanced, steady economic growth at high employment levels. In the past the economy has tended to grow in spurts. It has responded rapidly to new technology and new resources and then paused to "catch its breath". Or it has resorted to the excessive use of credit followed by a breakdown of the credit structure. This stop-and-go process has proved costly in many ways--unemployment, lost incomes, and the indiscriminate injustices of inflation. The Federal Reserve seeks to eliminate those imbalances that are caused by money and credit.

Stable economic growth with full employment is essentially a process of maintaining an appropriate balance between productive capacity and consumption. The recent story of the beef cattle industry furnishes an excellent example of the distinction between investment spending and consumption spending and of the need to keep the two in balance to avoid booms and busts. During World War II, consumer income was rising while much consumer spending, including that for meat, was limited by rationing. Then, when rationing was discontinued after World War II, everyone wanted meat and its price started to rise. As it rose, so did the price of cattle, and the raising of beef cattle became more profitable. Ranchers expanded their herds, and many newcomers, including "main street cowboys", entered the business.

With his understanding of the operation of the cattle business, my colleague Governor Shepardson interprets what happened as follows: A cow herd of a given size will produce just so many calves per year. Out of that calf crop a certain number must be saved for replacements in the breeding herd. Others are saved for herd expansion. The rest are available for consumption. If the rate of herd expansion is to be increased, the number available for current consumption must be reduced. Moreover, the enlarged breeding herd will not result in increased production until after two or three years because of the biological time requirement for reproduction and for growth to a profitable age for slaughtering.

From 1949 through 1951 competing demands for animals for consumption and for herd expansion forced prices higher and higher. Each rise in prices stimulated new producers to enter the field, and the cow population increased 25 per cent. At the same time, rising consumer prices cut the consumption per capita from 68 pounds in 1947 to 55 pounds in 1951, a shrinkage that was masked and offset by the higher demand for breeding stock.

By 1951, the increased production from the enlarged herd began to reach the consumer market and prices started to break. By 1952, widespread drought increased the marketings still further and accentuated the slide. Prices that had risen 50 per cent in two years fell by one half in the next two. Cows that cost $300 in 1951 dropped as low as $100 by 1953. However, these drastically reduced prices did stimulate consumption, from the low level of 55 pounds per capita in 1951 to ~~83~~ 85 pounds ~~last year.~~ in 1956. By now, prices have finally stabilized and turned upward after a most painful and costly readjustment.

If consumption is to expand, there must first exist the requisite productive facilities. This involves saving, which diverts resources from consumption. When the economy is operating at full capacity, neither investment nor consumption can be expanded further simply by inflating the flow of money with additional bank credit. Unless capacity and productivity are increased, additional credit will only result in bidding up of prices.

It is not the task, nor is it within the power, of the Federal Reserve to supply new savings for investment in housing or in business plant and equipment, or for the financing of the construction of schools and roads. Savings for these purposes must come chiefly out of current income that is not spent for consumption, because only through such savings are physical resources of men and materials released for investment.

Federal Reserve policies, even if properly attuned to the cash holding desires of the public, cannot always assure continued growth and stability. The maintenance of equilibrium requires the delicate balancing of an intricate structure of consumption and investment involving a great multitude of goods and services. No master mind can direct with assurance the smooth functioning of this complex mechanism. The forces of the market and the price system must be relied upon to direct the flows of money, goods and services into appropriate channels, and to keep them moving. There are bound to be obstructions and hindrances and slowdowns from time to time.

Stable growth in the economy as a whole is consistent with considerable instability in individual types of demand. A decline in government spending can be offset by a rise in private demand; an expansion in business investment spending can be offset by a decline in residential construction; higher investment in steel can be offset by lower investment in auto manufacturing. This is the phenomenon of the past half decade that has been described as a rolling adjustment. Different types of demand take turns acting as the driving force in the economy, and at all times total demand is more or less equal to total capacity.

There are actually two types of influence at work here. On the one hand, there is the competition among businesses and consumers, as well as governments--national, state and local--for shares of the total credit and goods available in the economy. To the extent that demand slackens in one of these sectors, there can be an increased flow to other sectors. This is the rolling sustained growth that we have been observing.

On the other hand, there is a mutual interdependence of demands: high consumer demand generates high business investment demand, and business investment generates income to stimulate added consumer demand. And, more to the point, a drop in investment demand, whether from an excess of investment relative to consumption in some important area or from the lack of adequate financing, can tend to drag down consumer demand by reducing incomes. This is the cumulative response to movements in individual industries that gives rise to booms and depressions.

The solution is not to be found in supplying sufficient bank credit to meet all credit demands without regard to economic merits. That route leads to outright inflation with all its hardships and indiscriminate evils. Rather the answer is to be found in making free markets work. If free markets are combined with sound monetary and fiscal policies, the long-term social gains from the economy depend upon the quality of the decision making of business and labor officials and of consumers.

The alternative to free markets is to resort to government subsidies, guarantees and tax benefits. These may shelter preferred groups and meet apparent social needs, but we must not forget that each time we use them we subtract from the credit, materials and labor available to others who must rely upon the free market. The greater the amount of special shelter provided by government, the more difficult becomes the situation of those not so protected. In a free society, it is axiomatic that not everyone can be sheltered. It is understandable, therefore, that free markets should be looked upon as the central feature of our private enterprise system.

How do growth and stability influence the role of the trust officer? I assume that, fundamentally, their role is to make the best choices among a mixture of certainties and uncertainties. But, the uncertainties have increased. The trustee's task is difficult enough in a world of reasonable stability; in a world of instability, the uncertainties are compounded and so are the difficulties of trusteeship. However earnestly he seeks a wise course of action, his long-run success will hinge in part upon the ability of the world's economies to achieve growth, and to achieve it without inflation.