The Role of the Federal Reserve System in Economic Stability

Remarks by Chas. N. Shepardson, Member, Board of Governors, Federal Reserve System, at meeting of American Association of Land Grant Colleges and State Universities, Denver, Colorado, on November 13, 1957.

Having spent forty years in Land-Grant College circles either as student or staff member, it is a real pleasure to have the opportunity of meeting with you again.

In discussing the role of the Federal Reserve in the maintenance of economic stability, we first need to consider what we mean by "economic stability." I am sure that no one has in mind the maintaining of the status quo. Certainly we want and expect a condition conducive to a continuing growth and development in our economy as a whole. A big part of the work of the members of this Association is devoted to the development of new knowledge and its application. Such work results in changes -- changes of products, changes of methods, and changes in relationships of the affected segments in our economy. Thus, it is inevitable that we have a degree of instability or dislocation from time to time as we progress.

Webster defines "stability" as applied to aeronautics as "That property of a body which causes it, when disturbed from a condition of equilibrium or steady motion, to develop forces or moments which tend to restore the body to its original condition." I like this definition because it seems appropriate to our type of economy. Our achievements to date and our hope for growth and development in the future are based in no small measure on our adaptability to change. Thus, we discard the fetters of habit or the established way and launch out on new paths. In so doing, we forsake the tradition-bound stability of the paved highway for the unlimited horizon of the skyways, knowing as we do that we shall be tossed and buffeted by the gyrations of the air currents but having faith in our ability to generate those counter forces which tend to restore equilibrium and direction -- in other words, stability. Just as stability is necessary for the successful flight of the airplane, economic stability is a prerequisite for orderly economic progress along the path of growth and development.

Perhaps the second question we should ask in connection with stability is -- stability of what? Is it stability of prices that we seek, or of output, or of employment, or of something else? Probably the best answer is that we seek something which encompasses part of each of these, and more besides. There is no simple unvarying measure of stability that we can check by reading the morning paper or even by studying a particular statistic, such as the index of wholesale or retail prices. The true measure of desirable economic stability is to be found in the broad picture of an economy that is growing and progressing and at the same time maintaining a healthy balance among the various aspects in which growth and change are being manifested. Broadly, we want our economic resources to be reasonably fully employed. We want growth in output, and we want more than anything to see a type of growth that permits us to expand our capital plant and at the same time to consume currently some of the fruits of our improvements. More especially, we want this growth to occur with an avoidance of the excesses of inflation and deflation which our past history has taught us to abhor.

Let us recognize clearly that we seek only to maintain a reasonable equilibrium in the economy as a whole. We cannot attain -- and we would not wish to attain -- the complete absence of all fluctuations in all segments of the economy. In a dynamic economic system there is a continual need for individual firms and particular industries to make adjustments to changing conditions of demand and supply, as well as to new techniques. These adjustments inevitably cause some fluctuations of prices and activity. They are, however, a necessary part of the growth process. It is only when concurrent adjustments in a number of industries and sectors of our economy threaten to set in motion the more widespread and extreme up-or-down swings that our economic stability is endangered. It is these disruptive swings that we must all be alert to recognize and strive to contain before they attain destructive force.

I have spoken of the need to encourage balanced growth. What are the main ingredients of that balance? I think we would all agree that the most significant aspect of balanced growth in our economy is the balance between the demand for capital goods and the demand for consumption. To put it in another way, the basic requirement for the avoidance of inflation in our economy is that the demand for new investment should be roughly equivalent to the volume of voluntary saving.

I can think of no better way to illustrate this vital relationship than by citing an example which must be well known to all of you -- the postwar changes in the cattle population in the United States. At the end of the war, as rationing was discontinued, the demand for beef was, you will remember, very strong. Prices were rising. Most farmers and ranchers, responding to these better prices, wished to build up their herds in order to increase beef production. As we all know, however, the increased retention of cattle on farms reduced cattle available for slaughter, with the result that the tendency for prices to rise was accentuated. This development in turn strengthened the desire of farmers to build up their herds still further.

We have here a perfect example, applicable not only to cattle but to the economy as a whole, of the fact that the desire to consume and the desire to build up our capital stocks compete with each other, and if both are strong this competition tends to result in an inflationary movement. With respect to the cattle industry, as you all know, the sequel was that the building up of herds continued for some time and that when the greatly increased herds began to produce beef for the market on a large scale, prices declined very substantially. The same thing tends to happen in an entire economy after a prolonged race between the competing demands of consumption and capital building. In the case of the whole economy, the movement tends to be exaggerated if the expansionary phase is based too much on increases in bank credit and other debt. In the past, such inflationary movements have resulted in recessions or depressions, with all of the economic wastage of idle labor and idle capital incident to them.

The importance of saving and capital creation as an essential feature of economic growth cannot be overstated. Our much vaunted standard of living in this country is primarily the result of increased productivity per man-hour of labor. This productivity in turn is the result of the substitution of capital in the form of improved equipment methods and materials for human labor, and the release of that labor for other productive use. With our growing population and our continuing desire for a higher and higher standard of living, it should be obvious that we need an ever-increasing supply of capital. However, at times when all or nearly all the resources of the economy are fully employed, an increase in the rate of capital formation is possible only by reducing consumption; otherwise, the obvious result is inflationary price rises as consumers and investors compete for the limited output available.

When capital and consumption demand compete with each other under the conditions just described, there is a tendency for increasing numbers of individuals, businesses and governmental units to seek to borrow in order to spend. Thus, such a period is always marked by a pressure for credit expansion. The preservation of stability therefore requires that not all of the requests for credit be met. As credit restraints are brought into play, the available supply of credit falls short of current demands and interest rates tend to rise. The effect of the rise in cost and reduced availability of credit is felt both by consumer borrowers and investor borrowers. So far as the investors are concerned, some investment plans are likely to be reduced or postponed. As far as consumers are concerned, not only are they somewhat discouraged from borrowing by the higher interest rates but they may also be encouraged to save more because of the higher rates available on savings.

Here I would point out that there are two essential factors in the stimulation of saving. Certainly one of these is the rate of return available to the saver. What I think we often overlook, however, is the more important fact that the will to save depends to a large extent upon the saver's confidence that his savings will not be damaged by inflation. Thus, credit restraint plays an important part in preserving balance in the economy by helping to assure savers that their savings will not be eroded by continuing inflationary price increases. In my opinion, one of the greatest dangers of the recent situation in this country has been the apparent growing acceptance by many people of the belief that prices in the future will continue the recent pattern of more or less steady rise. If such a conviction becomes widespread, more and more people will take action to buy now rather than later, to build homes and plants now rather than later, and generally to spend instead of saving. We all know that the inevitable result of such action, if it becomes sufficiently widespread, will be that inflation will cease to "creep" and begin to "gallop." All our past experience tells us that such developments court disaster not only because of the disruption and inequities that come with inflation but because rapid inflation is inevitably followed by collapse and depression. To the extent that credit policies and other measures designed to restrain such inflationary excesses are successful, they are of course doing their most important job in preserving economic stability.

Let us turn then to the position of the Federal Reserve System relative to these problems of stability that we have been discussing. The Federal Reserve System differs in important respects from most other central banks. The basic difference lies in the fact that instead of a single central institution, government owned, the Federal Reserve consists of a Board of Governors in Washington, twelve district Federal Reserve Banks, and twenty-four branch banks, each with their corps of officers and board of directors. It is thus more properly described as a central banking system than as a central bank.

The creation of a decentralized system was part of a deliberate plan on the part of Congress at the time of the passage of the Federal Reserve Act in 1913. Congress wished to secure the main advantages of a central bank while avoiding a highly centralized and purely government-operated institution. Although legislation passed subsequent to 1913 has considerably strengthened the powers of the Board of Governors in Washington, it would be a mistake to regard the Federal Reserve as simply a Washington institution. The officers and directors of the regional banks play an important part in shaping and executing Federal Reserve policies.

As you know, most of the hand-to-hand money in the United States consists of notes issued by Federal Reserve Banks. The total amount of coin and currency in circulation at the present time is approximately 31 billion dollars, of which more than 26 billion consists of such Federal Reserve notes. Of far greater importance, however, are the approximately 106 billion dollars of commercial bank deposits or checkbook money in the country which in our economy constitute the bulk of the real money. This bank deposit money, consisting as it does of the demand liabilities of commercial banks, has in a practical sense been created by the private banking system as a result of the lending and investing activities of roughly 14,000 private banks. In our system, the amounts which private banks are capable of lending and investing, and therefore their ability to create greater or lesser amounts of bank deposit money, depend upon the ability of these banks to acquire the reserves which under the law they must hold with Federal Reserve Banks. Hence, Federal Reserve control over the volume of bank credit (which means control over the volume of money) is exercised indirectly by influencing the amount of Federal Reserve credit available for commercial banks to hold as reserves.

Specifically, the Federal Reserve System has three basio tools for the control of bank credit, namely, changes in reserve requirements, rediscount rate changes, and open market operations, together with certain more specialized controls.

Since the lending and investing power of commercial banks depends on the adequacy of bank reserves as required by law, any changes in minimum legal reserve requirements obviously will have a direct impact upon the credit creation process. Under the Banking Act of 1935 the Board of Governors of the Federal Reserve System was given the power, within limits, to change reserve requirements of member banks. Board action to raise reserve requirements obviously tends to curtail the lending and investing powers of private banks, whereas reductions in reserve requirements will facilitate and perhaps encourage bank credit expansion. While this is an important tool in effecting major changes in availability of reserves, it is a blunt one, poorly adapted to short run changes since, among other things, it affects all banks regardless of varying local conditions at any given time. Hence, its use is infrequent.

The second major instrument of credit and monetary policy is the rediscount rate or the rate of interest member banks pay when borrowing from Federal Reserve Banks in order to meet temporary adjustments in their reserves. The Board of Directors of each Federal Reserve Bank fixes the rediscount rate for its District, subject to the approval of the Board of Governors. The effect of such changes upon the credit situation is sometimes misunderstood.

In the first place, it should be emphasized that such borrowing is a privilege and not a right. It is no secret that Federal Reserve Banks frown on continual and extensive borrowing by any one bank. This fact, together with the natural reluctance of prudent bankers to incur such indebtedness, accounts for the strong tradition in American banking against such borrowing. To the extent that member banks do borrow (and at any moment there are always some banks that are indebted to the Federal Reserve) obviously higher rediscount rates act in some degree as a deterrent to borrowing and lower rates make banks more willing to borrow.

In the second place, I want to make it clear that the rediscount rate in no sense rigidly determines interest rates in the economy as a whole. In general, interest rates in the economy reflect demand and supply conditions in a number of markets in which funds may be borrowed. Often in the past, changes in rediscount rates have tended to follow rather than to lead market rates. Nevertheless, rediscount rate changes do reflect Federal Reserve thinking about credit conditions and unquestionably have some influence on the willingness of member banks to borrow and on the general state of credit.

The third weapon of credit and monetary policy, and in a sense the most basic of all, is that of open market operations. Federal Reserve Banks buy and sell certain securities, primarily U. S. Government securities, in the open market. Such purchases and sales are made through the New York Federal Reserve Bank for all twelve banks. Their volume and timing are determined by the System Open Market Committee, composed of the seven members of the Board of Governors and five additional members chosen from the presidents of the twelve Federal Reserve Banks. Since Federal Reserve purchases add to Federal Reserve credit held by the economy generally, such purchases result in additions to member bank reserves, thus enabling these banks to expand their own credit. Conversely, Federal Reserve sales deprive member banks of reserves and tend to restrict the credit-creating activities of the banking system. Since either purchases or sales may be made on any day in large or small amounts, open market operations constitute an ideal instrument for making day-to-day adjustments in the reserve positions of member banks. Such operations therefore are used extensively to offset seasonal and other temporary changes in the economy's need for credit, as well as for the broader purpose of influencing the economic "climate" generally.

In addition to the three principal weapons just mentioned, the Federal Reserve System has had from time to time certain "selective control" instruments, so called because they influence only one particular sector of the economy. At present the Board has only one such instrument, namely, the power to fix minimum margin requirements for stock purchases.

As I indicated earlier, it is important to emphasize that Federal Reserve System decisions involving the use of credit control instruments reflect the thinking not only of the Board of Governors but of officers and directors of the twelve Federal Reserve Banks. We noted that rediscount rates are fixed by the Board of Directors of the Federal Reserve Banks subject to the approval of the Board of Governors in Washington. Although Board approval gives us the final word, the participation of Federal Reserve Bank presidents and other officers is a substantive participation, and action is taken only after a thorough discussion among all parts of the System.

The same is obviously true of open market operations, where five Federal Reserve Bank presidents participate fully in all discussions. (I might add that the seven Federal Reserve Bank presidents who are not serving on the Open Market Committee at any moment normally participate in discussions which shape open market policies.) The essence of effective credit and monetary policy is flexibility and constant reappraisal, and it is my conviction that the System as presently constituted lends itself extremely well to such a process.

In the past two years there has been much public discussion of the role of monetary authorities in economic developments. We often hear that the Federal Reserve System determines the amount of money in the economy and fixes interest rates. Such statements tend to be misleading because they overlook the basic characteristics of our economy in which market forces play such a predominant part. It is not correct to say, for example, that the Federal Reserve System has created tight money. Fundamentally, tight money has been created by the overwhelming demand for credit which has recently characterized our rapidly expanding economic system. This is not to deny that Federal Reserve policy is an influence. It is within the power of the Federal Reserve System to manufacture enough new credit so that money will not be tight. However, were the Federal Reserve to create enough new credit to meet all demands during a period of inflationary pressure, it would fail in its basic duty to aid in the maintenance of stability, first of prices and ultimately of the entire economic structure.

It should be pointed out, by the way, that in the recent past credit restraint has not been so great as to reduce, or even to prevent some increase in, the money supply. True, the total of currency and demand deposits has grown only about half a billion dollars in the last twelve months. At the same time, however, there has been a significant increase in the rate of deposit turnover, which has further increased the effective supply. It is therefore incorrect to infer, as is sometimes done, that recent credit and monetary policy has actually reduced money supply. Actually, the money supply has been permitted some growth in order to meet the requirements of a growing economy but restraints have been imposed to prevent increases that would serve only to feed the inflationary movement.

Similarly, it is incorrect to say that either the Federal Reserve or the Treasury has promoted high interest rates. Continuing strong demands in the credit market have been the main force pushing interest rates up. To the extent that anti-inflationary restraints have limited the bank credit and monetary expansion, they have certainly had an indirect effect on interest rates. Basically, however, the traditional patterns of demand and supply forces in a free market have determined interest levels. In periods of slackening credit demand we would expect market interest rates to recede.

Needless to say, the effective use of monetary instruments to preserve reasonable stability requires their prompt application in deflationary as well as inflationary situations. The basic strength of monetary policy is its flexibility and adaptability to changing economic conditions. The same instruments that have been directed against inflationary forces in the past two years can quickly be reversed if the occasion demands. Current developments in our economy emphasize the problems involved in setting the appropriate course of credit and monetary policy at a given time. In recent months, for example, the demand for new plant and equipment has been leveling out. Demand for bank loans is currently not showing the strength that was evident a year ago. Recent stock market action has revealed some uncertainties in investor sentiment about business prospects. On the other hand, there are many indications of continuing growth and the consumer price index has continued to move up. Each of these developments and many more are under constant study in making the decisions that shape Federal Reserve policy.

One other fact in connection with monetary controls remains to be emphasized. Credit and monetary policy is not the only instrument available for the control of inflation. In order for such policy to be most effective, it is always desirable, and in certain situations imperative, that an appropriate fiscal policy be pursued. As we all know, the main ingredient of inflation is an excessively high level of overall demand for goods and services. In the past fifteen years the proportion of total demand represented by government spending has increased greatly. It seems clear that during periods of high demand the tax income of government should be at least sufficient to balance expenditure. But as inflationary pressures mount, this may not be enough. Here a substantial Treasury surplus may provide a powerful weapon for combating inflation. Conversely, during contractive and deflationary periods, tax reductions and increases in government outlays can serve as important measures to counteract the decline in overall demand.

I should like to make one further point. In a free enterprise economy the achievement of economic stability requires more than appropriate government action. It requires that private individuals, be they consumers, workers, or employers, act with restraint in periods of inflation and with calmness and a basic faith in our future during periods of tendency toward deflation. Basically, an unwillingness to be "stampeded" in either direction by short-run developments can of itself contribute tremendously to the maintenance of stability.

Thus, while appropriate credit and monetary policy is indispensable to the maintenance of stability, we should never make the mistake of placing sole reliance on it. Maintaining our stability in a free private enterprise economy requires a balanced combination of fiscal and monetary policy, together with intelligent self-discipline on the part of private citizens, both individually and collectively.