OUR ECONOMIC CONTROLS AND POLICIES

Speech by Darryl R. Francis, President,
Federal Reserve Bank of St. Louis,
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It is good to have this opportunity of discussing some of the nation's economic problems at this meeting in memory of the "Kingdom of Callaway." I am honored to be included among those outstanding speakers who have heretofore addressed this group. Like the milita groups that gathered here during the early Civil War days, we are still vitally interested in public policies. I shall, however, limit my remarks to those policies that have an impact primarily on economic activity.

In order to provide an appropriate setting for public policies relative to economic activity, I shall review the course of our economy since the current upswing began in early 1961. In this review I have divided the seven years under discussion into four sub-periods, 1961 through 1964, late 1964 to early 1966, early 1966 to late 1966, and late 1966 to date.

During the first period, 1961 through 1964, steady economic expansion occurred. As a result, unemployment was reduced from about 7 per cent of the labor force in early 1961 to less than 5 per cent in late 1964. Industrial plant utilization rose from 75 per cent to 86 per cent of capacity. These gains were accomplished in an orderly fashion without great frictions, shortages, or imbalances, and the trend of prices did not deviate substantially from a 1.5 per cent upward trend rate.

Major tools of economic stabilization were moderately stimulative in this period of balanced economic expansion. Growth in the money stock of the nation was at a 2.7 per cent annual rate compared with an average 2 per cent rate in the previous decade. The influence of fiscal actions (government expenditures and taxes) on the economy became more expansive.

During the second period, from late 1964 to early 1966, the pace of economic expansion quickened. This period was marked by the acceleration of military purchases for Vietnam. Total spending on goods and services rose at a 10 per cent annual rate. Most of the increase in spending was matched by a 7.7 per cent rate of gain in

real output. The rapid expansion in output further reduced unemployment from about 5 per cent to less than 4 per cent of the labor force and increased industrial plant utilization from 86 per cent to over 90 per cent of capacity. Prices rose at the somewhat faster 2 per cent annual rate from late 1964 to early 1966, but considering the rise in total demand, the rate of inflation was less than might have been expected.

Fiscal and monetary actions were very expansionary during this period. The Federal budget became more stimulative. It moved from a surplus of $6 billion in 1964 to a near balance in early 1966.[1/] The monetary authorities provided reserves to member banks in order to avoid a sharp tightening in credit conditions in response to the strong credit demands. The reserves provided for a rapid expansion in commercial bank credit. This, in turn, caused the growth of money to accelerate. The rate of gain in the stock of money rose from the 2.7 per cent rate in the earlier period to a 4 per cent rate from mid-1964 to the spring of 1965, and further to a 6 per cent rate from the spring of 1965 to the spring of 1966. This acceleration in monetary growth was very expansive.

In the third period, from early 1966 to late 1966, the rate of growth in total spending slowed somewhat. However, relative to the ability of the economy to produce as it approached capacity, total

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1/ Data apply to the high-employment budget.

demand remained excessive. The upward climb in over-all prices rose from the 2 per cent rate in the previous period to a 3 per cent rate in this period.

Monetary restraint was an important factor in the slower growth in spending in late 1966. From April 1966 to January 1967, there was little change in the money supply -- a very restrictive monetary action compared with the 6 per cent increase in money in the previous 12 months.

By the fall of 1966 a restraint on spending was noticeable. Some spending units began to reduce outlays to conserve cash and revised their expectations downward. Credit demands tapered off. Interest rates, after reaching a peak in the early fall, declined until early 1967. Lower rates gave an impression of an easier monetary situation despite continued slow growth in the money stock. Final purchases by the private sector (gross national product less Federal Government outlays and net purchases of inventories) slowed to a 4.4 per cent rate from the first to third quarters of 1966 and further to a 2.6 per cent growth rate in the final quarter of 1966. In comparison, such purchases grew at about a 10 per cent rate from late 1964 to early 1966.

The marked slowing in the growth of final spending by consumers and businesses during 1966 was partially offset by accelerations in

Government spending and by some, apparently undesired, increases in business inventories.

Despite the pause in economic growth in late 1966, inflationary pressures remained strong. Over-all prices increased at a 2.3 per cent annual rate in the first half of 1967, following the 3 per cent rate of increase in the previous three quarters. Much of the slowing in price increases reflected a changed supply situation in agricultural products, bringing about a decline in quotations for farm products, processed foods, and feeds.

In the fourth period, late 1966 to date, activity first declined somewhat and then accelerated sharply. Of the two major tools of the Government for influencing the pace of economic activity, one was a stimulative force and the other was a restraining force in early 1967. Fiscal actions provided a strong upward thrust to spending; in fact, spending by Government (Federal, state and local) accounted for the entire increase in total spending in the first half of 1967. These outlays, through the "multiplier," probably had a stimulative effect on consumer and business expenditures. The lack of growth in money from the spring of 1966 to early 1967 had a dampening effect on private spending.

Sometime during the late spring of 1967 another marked and sustained change occurred in the pace of economic activity. Total spending rose at an estimated 9 per cent annual rate in the last half of 1967 after going up at a 3.4 per cent pace in the first half. Real

output of goods and services, which had changed little on balance early in the year, expanded at an estimated 5 per cent annual rate in the last half despite several major strikes.

This change from economic pause to rapid growth can be attributed to both fiscal and monetary developments. Each was very stimulative in the summer and fall of 1967. The sharpest change, however, was in monetary factors. The money supply rose at the rate of 7 per cent after having remained unchanged during the previous period. Fiscal actions, which were already the most stimulative since World War II, may have become slightly more expansive.

Summarizing developments since 1961, the combination of fiscal and monetary policies provided balanced and steady economic expansion until the end of 1964. In late 1964 these policies became more expansive, and by early 1966 demand for goods and services became excessive, and noticeable price increases occurred. Monetary restraint beginning in early 1966 began to slow expansion late in the year, and by early 1967 activity was showing virtually no growth. Despite the pause, however, inflationary pressures remained strong in the first half of 1967. By late spring, economic activity had turned up again as a result of stimulative fiscal and monetary policies. The upswing continued through the year with substantial price inflation during the last three quarters.

As a result of this excessive demand and price inflation, the Federal Reserve System has taken two steps which generally point to less expansive monetary conditions. Last November the System raised the discount rate from 4 to 4-1/2 per cent on eligible paper of member banks. More recently reserve requirements of the larger member banks were increased.

Because of these moves and the upward trend of interest rates in recent years, great concern as to the probable course of interest rates has developed. I shall comment on this topic by addressing myself to the question of what would likely happen if less expansive fiscal and monetary policies are adopted. In answer, I suggest that total demand for goods and services would decline from the current excessive levels after a brief time lag. This would reduce pressure on the capital markets and tend to lower interest rates. But a more immediate impact on rates would probably occur as a result of reduced government borrowing and more stable price expectations.

Government deficits necessitate borrowing, and such demands for savings have the same upward pressure on interest rates as a similar amount of borrowing in the private sector. Less Government spending or higher taxes would reduce the deficits, thereby reducing needs for credit and the accompanying upward pressure on interest rates.

Government deficits can be financed in two ways: through money creation (non-interest bearing government debt) or through sales of securities (interest bearing government debt). As a continuous and permanent program, I can see substantial flows in either method of financing government expenditures. Although I am reluctant to compare government financing to that of the individual firm or household, over the longer pull, it appears to me that each must be brought into balance with income. Another similarity is that in both cases decisions must eventually be made as to what we can afford, given the level of resources that the people are willing to allocate to public use. This problem has a fairly simple solution in the case of most individuals and firms. Restraining influences come to bear rather quickly when excessive debts are created by households. The restraining influences are more subtle, however, in the case of governments. Their securities are still marketable. Money is still acceptable. The problem is that interest rates are higher than they would otherwise be and that the dollar has less purchasing power. We thus pay for excessive government expenditures through reduced purchasing power of the currency and through a reduction in value of all dollar denominated securities and debt.

It appears to me that this nation should take a closer look at its income and resources and come to some decision as to what it can afford to spend in the public sector, given the self-imposed tax limitations of its citizens. Like the individual household, it should then limit its expenditures to its income, given perhaps some leeway for deficits during periods of serious recessions and surpluses as such recessions recede.

The effect of rising prices on interest rates is often overlooked. Nevertheless, it is quite real. Savers must protect the purchasing power of funds lent, and borrowers are willing to pay higher rates if they expect to repay in cheaper dollars. For example, if savings through the investment route yield a real rate of return of 4 per cent and prices are rising 3 per cent per year, savers would require a stated rate of 7 per cent to realize the 4 per cent real return on their savings. In this case, if savers have an opportunity to invest in capital goods where real rates of 4 per cent are still obtainable, savings institutions must pay a comparable rate to obtain loanable funds. Borrowers are as willing to pay the 7 per cent when they expect prices to rise at a 3 per cent rate as they are to pay 4 per cent under stable price expectations. It is this upward pressure on nominal rates necessary for a constant real rate of return that has pushed the nominal rates up to such high levels during the past two years.

What will happen with a less expansive monetary policy? In answer, I shall comment again on 1966 developments when these policies prevailed. You will recall that interest rates rose for about 3 or 4 months after the stock of money stopped growing. Demand for goods and services, however, soon began to moderate and a reduction in rates followed. The more restrictive actions occurred in the second quarter of 1966, and by late September interest rates began to decline.

From these comments you can conclude that I am not impressed with fears of higher rates or a money crisis resulting from less expansive monetary operations. To the contrary, I suggest that the expansive monetary and fiscal policies of recent years have been the important factors that pushed interest rates up. A somewhat less expansive monetary policy than prevailed through most of 1967 would likely result in less demand for goods and services, more stable prices and, after a short time, lower interest rates.

While on this topic of interest rates, I would also like to point out that most of the so-called "money crisis" or "credit crunch" in 1966 reflected legal impediments to proper market functions. Many states have excessively restrictive laws with respect to interest rates. Such laws which limit rates paid and charged by savings institutions, i.e., commercial banks, savings and loan associations, etc., may do great damage to local communities.

When the supply and demand situation with respect to loanable funds calls for high interest rates, savings institutions must both pay and charge the higher rates or savings will find other outlets where the real rate of return is greater. Savings firms operating in such areas thus fail to grow at the same rate as such firms in freer market areas. These slower growing firms thus do not get the funds to lend and credit becomes unavailable to their customers. It thus appears to me that most state restrictions on rates bear heaviest on those institutions and borrowers whom the restrictions are designed to help. Conversely, they aid the Federal Government, large businesses, and others that can successfully tap the central money and capital markets where rates are free to move with basic supply and demand conditions. The young borrowers, the innovators, and the fast-growing firms that would be willing to pay some premium for risk are excluded from credit markets in these communities.

The Dollar and Gold

In connection with monetary problems, apparently one of the more misunderstood relationships is that between the dollar and gold. Some people believe that the size of the gold stock held by the U. S. determines the value of the dollar. For all practical purposes, gold has been detached from domestic money since 1933. It is still used for settling international transactions, and as long as

such transactions are settled in this manner, a stock of gold is desirable. On the other hand, in our domestic economy, gold is only used for commercial and industrial purposes. The price of gold is set by law at $35 per ounce. This only means that the U. S. Government stands willing to pay $35 per ounce for gold and will sell gold to foreign governments and governmental agencies at this price. The fact that the gold price is set at $35 per ounce does not mean that gold determines the value of the dollar. On the contrary, the value of the dollar has for several decades determined the price of gold. Furthermore, the productive efficiency of our domestic economy, coupled with fiscal policies and the stock of money, determines the value of the dollar. A rapid increase in the number of dollars causes prices to increase and the value of the dollar to depreciate. Conversely, a decrease in number of dollars causes their value to appreciate. Thus, if we can find some means of settling international payments without the use of gold, we can drop gold from our monetary system completely without any impact on our domestic economy and without any gain or depreciation in the value of money. Gold supplies can then be used for tooth filling, watch cases, and other ornaments, rather than being held under guard by governments at great expense. We might view our dollar-gold relationship in the same manner as our price support programs for farm products. For example, if the price is set too high, we

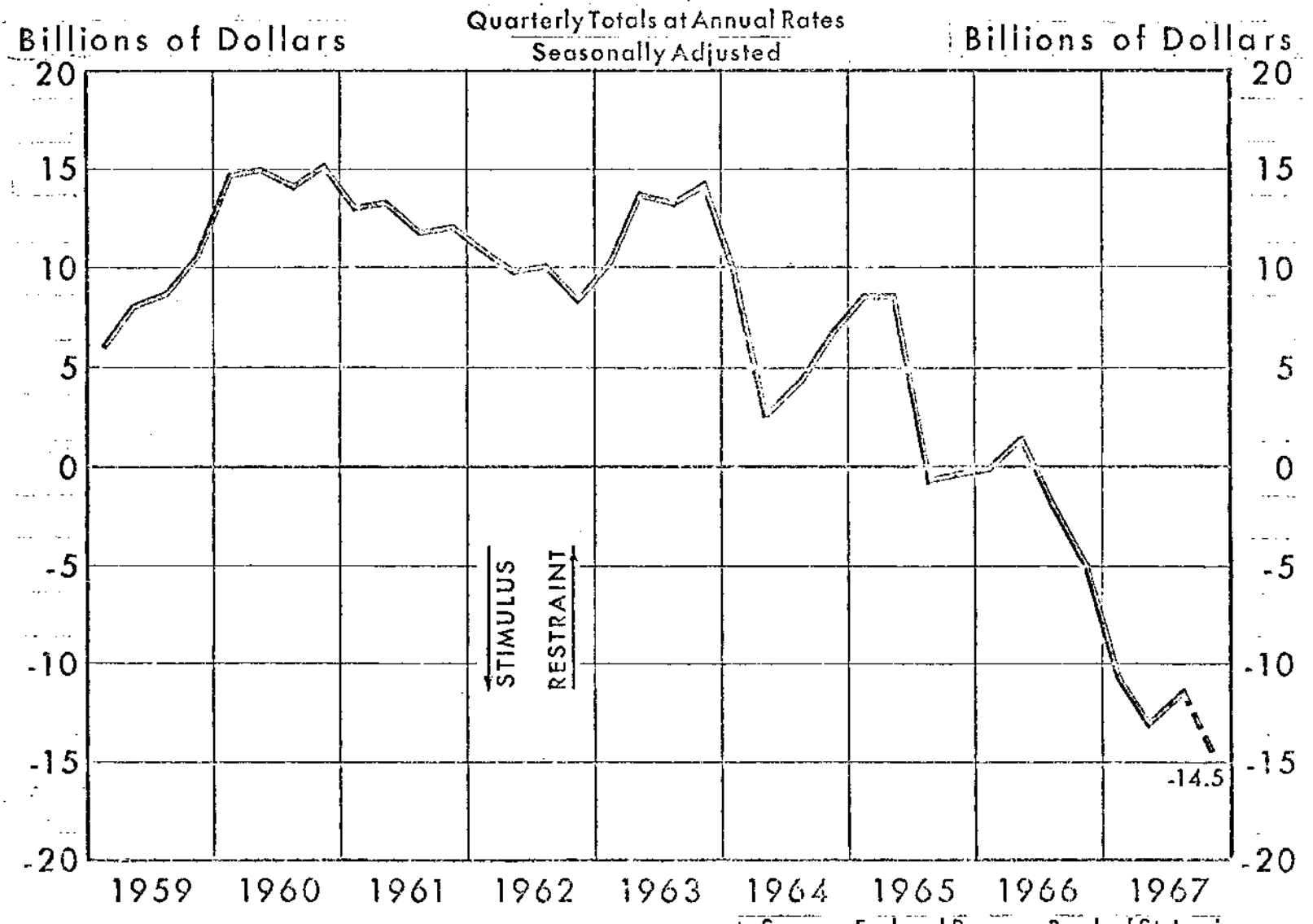
accumulate a stock of gold. On the other hand, if the price is set too low, our gold stock is depleted. That is the case today, since we are losing gold abroad. If we removed dollar-gold price relationships completely, however, we do not know what would happen to the price of gold. It might decline.

Another group views the current dollar-gold relationship as being beneficial because of the constraint it places on domestic money creation. For example, the legal requirement of 25 per cent gold backing for all Federal Reserve notes outstanding ultimately places a limit on the volume of money creation. In the periods, however, that such restrictions have been effective, they have proven harmful to the economy. Such restrictions are more likely to cause destabilizing monetary policies than policies which contribute to maximum stability and growth. Thus, in recent decades when monetary expansion has approached the legal limits as measured by the gold stock, the limits have been changed so as to permit an orderly increase in the stock of money.

Since we are not willing to submit to the drastic restrictions imposed on monetary policy by rigid gold ties, I see little reason for maintaining any domestic ties whatsoever with gold. In fact, as indicated earlier, such ties have not really existed since the early 1930's.

Federal Budget Influence*

Stimulus or Restraint

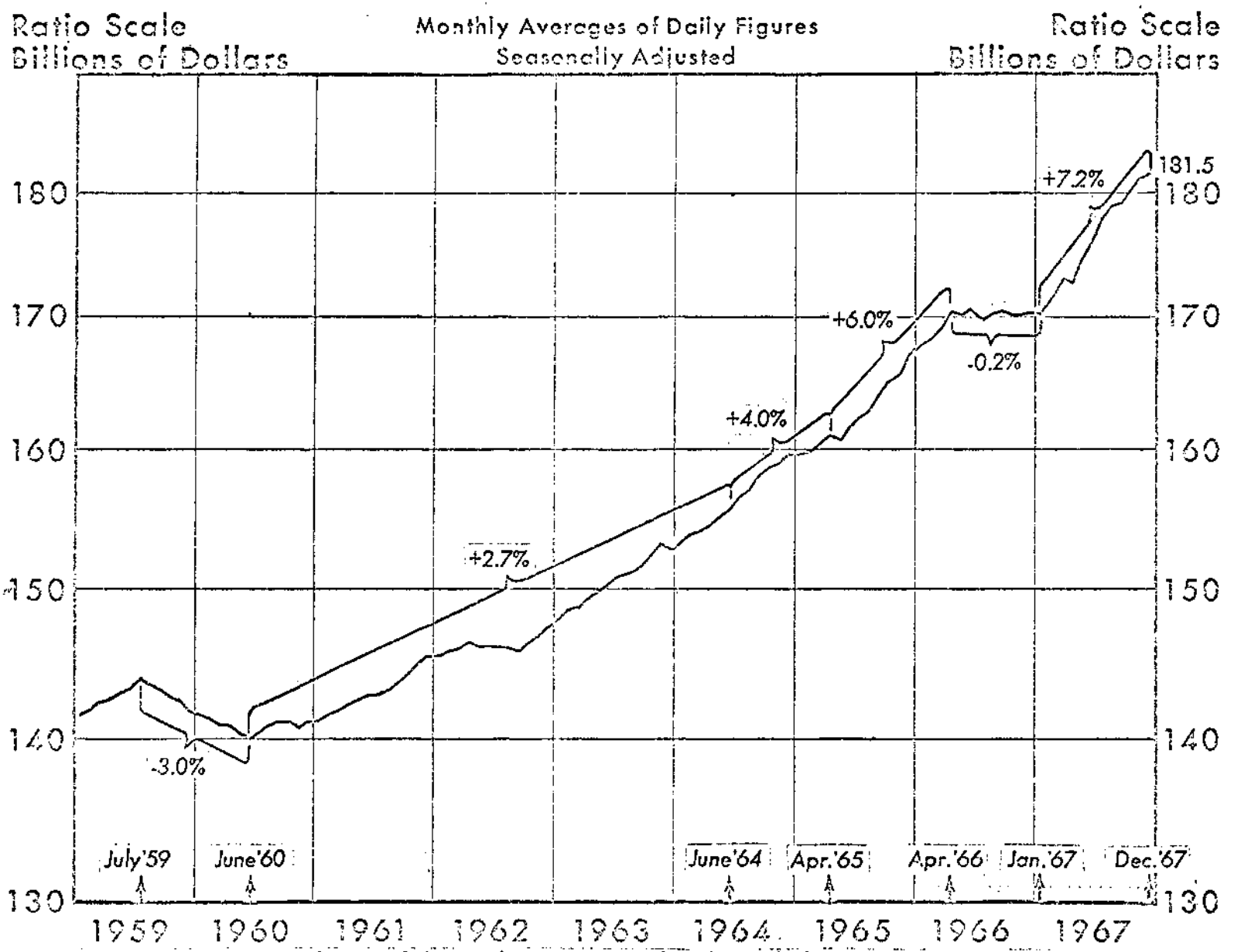


* Source: Federal Reserve Bank of St. Louis

*The High-Employment Budget, first published by the Council of Economic Advisers.
Latest data plotted: 4th quarter estimated

Prepared by Federal Reserve Bank of St. Louis

Money Stock

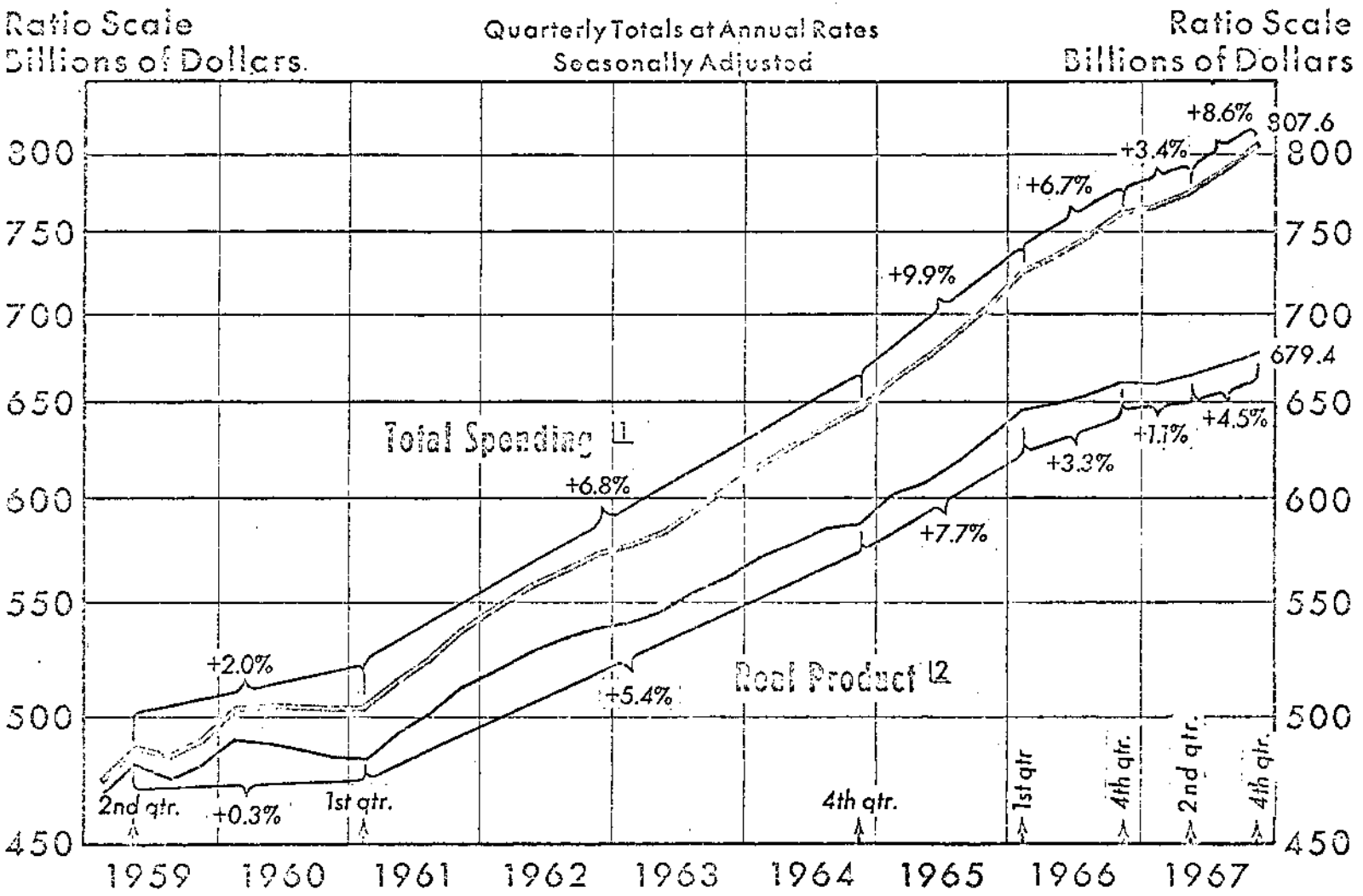


Percentages are annual rates of change between periods indicated. They are presented to aid in comparing most recent developments with past "trends."

Latest data plotted: December preliminary

Prepared by Federal Reserve Bank of St. Louis

Demand and Production



1 GNP in current dollars.
2 GNP in 1958 dollars.

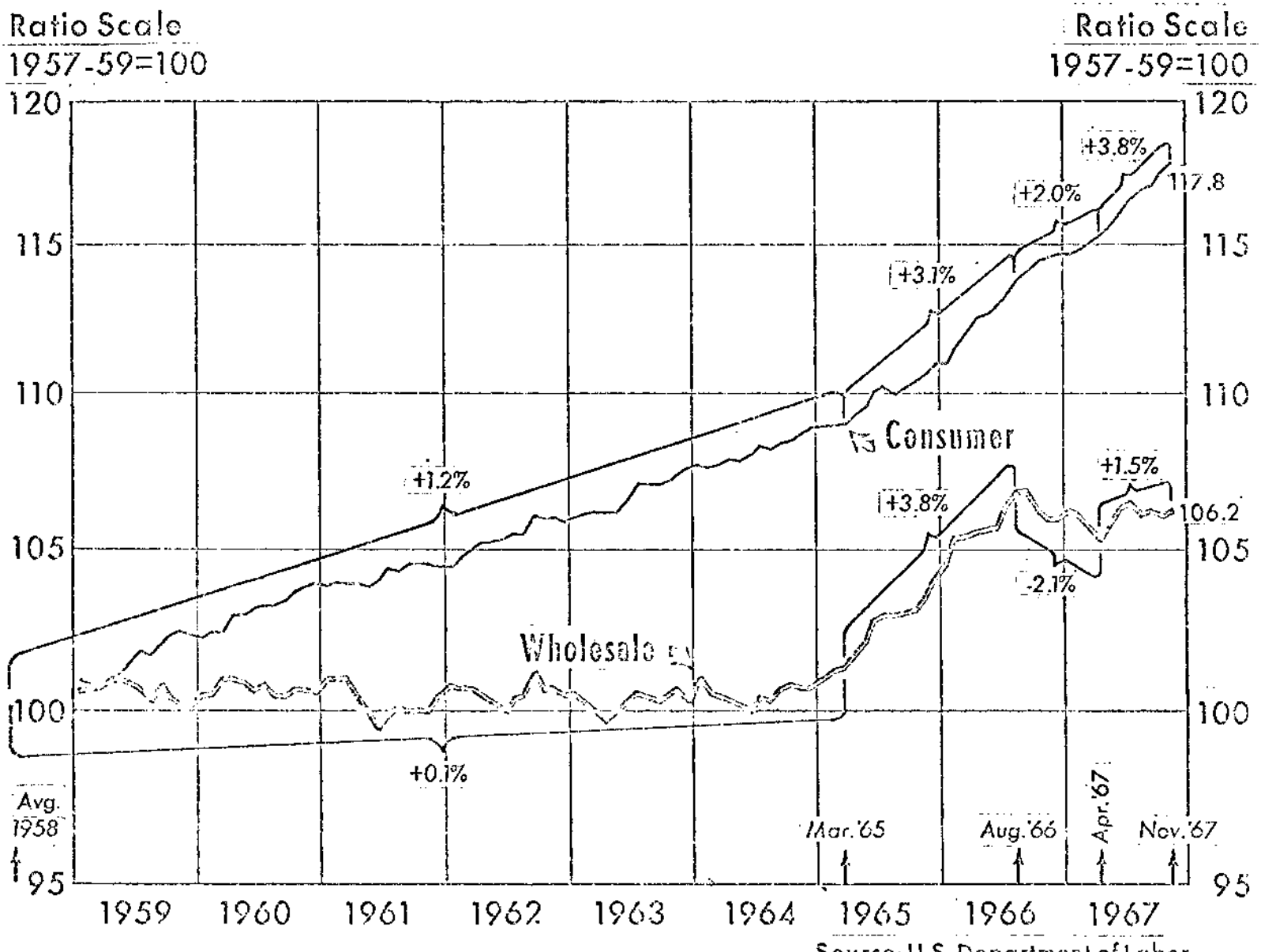
Source: U.S. Department of Commerce

Percentages are annual rates of change between periods indicated. They are presented to aid in comparing most recent developments with past "trends."

Latest data plotted: 4th quarter preliminary

Prepared by Federal Reserve Bank of St. Louis

Prices



Source: U.S. Department of Labor

Percentages are annual rates of change between periods indicated. They are presented to aid in comparing most recent developments with past "trends."

Latest data plotted: November preliminary

Prepared by Federal Reserve Bank of St. Louis