

M O N E Y M A T T E R S

Talk given by

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MONEY MATTERS

I am supposed to talk to you this afternoon about money matters. This kind of title gives me a lot of latitude and I intend to use it and talk about the impact of money and credit policy upon the economy, particularly about the impact upon interest rates and their effect upon economic life.

This is of importance to you people because currently about 11 percent of the total capital in agriculture is borrowed capital or debt. A little more than half of this \$18 billion in farm debt is secured by farm real estate -- slightly less than half is secured by other farm assets or is loaned without security.

In dollar volume, the trend of farm debts has been rather steadily upward. Real estate obligations of farmers increased an estimated 9 percent during 1956 -- non-real-estate debts by a more moderate increase. The rate of increase in non-real-estate farm debts seems to have slowed measurably during recent months.

It seems to me that it might be well to begin by trying to define what money and credit policy is supposed to do and why. Expressed in very simple terms, monetary and credit policy is simply an effort to answer the question: How much money should the country have? In this use, "money" means both bank deposits and currency; together these form the money supply of the nation. By far the larger portion of the money supply is "checkbook money" or bank deposits.

The broad objective of monetary policy then is to keep the supply of money in reasonable balance with the supply of goods and services in the economy. Again in simple terms, too much money tends to drive prices up, too little tends to inhibit economic growth and development. There have been periods in our lifetime when the economy experienced unnecessarily severe

setbacks for lack of money, and other times when many people were injured because there was too much money chasing a supply of goods and services that could not be expanded quickly, the classic inflationary situation.

The job of trying to determine how much money and credit should be supplied to the economy is tough and difficult. As I noted earlier, too much or too little money are both bad. Somewhere between too much and too little is a "right" amount. The difficulty comes because there is no magic formula to tell how much is "right". Decisions have to be based on comprehensive and continuing analysis of the whole complex economy. This means that a lot of information has to be studied, analyzed and digested. And in the final analysis, the very important factor of judgment comes in. Someone once said that central banking is an art and not a science. It is based on the judgment of men who are supposed to know enough to know that economic relationships change, that economics is concerned with people who are not very predictable, and that good central banking never tries to commit itself for long periods in the future but is a continuous process.

Having given the what and part of the why of monetary policy, it may be well to add this note, also partly the answer to why. We have to have monetary and credit policy to keep the supply of money in balance with the needs of the economy, because if we did not the balance probably would be lacking most of the time. A famous British economist said, almost a hundred years ago, "Money will not manage itself". At one time, far in the past, when money consisted mostly of gold and silver and when economic affairs were fairly simple, regulation of the money supply was not so important -- although even then it got out of balance every once in a while. In the past two hundred years, however, we have had a series of industrial revolutions and the economy today is a very complex thing. Modern finance also is pretty complicated and we now have a money system with great flexibility to contract or expand upon

demand. Thus the phrase "Money will not manage itself" is even more applicable today than it was when first stated.

You might think of the situation in this way. Back in the horse and buggy days, when there was not much traffic, you could in a pinch let the horse find his way home without guidance and be reasonably sure of getting there. Today, even with power steering and automatic transmissions, it would hardly be regarded as good driving to try to let the modern auto do that. And, actually the simile would be more pertinent if we compared the horse and buggy to the jet airplane.

Well, so much for the first aspects of "what" and "why". Now, let's look into the question of "how" money and credit policy tends to work. And in approaching that question it seems desirable to provide a setting. Both because the basic trend since World War II has been inflation and because the story of "how" can be illustrated best against an inflationary background, I take the familiar inflationary spiral as the backdrop to the discussion.

Once in operation, an inflationary spiral has strong tendencies to feed upon itself. Because prices are generally expected to rise, the incentive to save is diminished and the incentive to spend is increased. With the economy operating at relatively full capacity, further increases in spending simply cannot result in quick corresponding increases in production, but instead are expressed in mounting prices, wages and costs. These developments tend to undermine the very foundations of balanced industrial growth. They lead to imbalances of productive capacity and of credit and may set the stage for hard problems of readjustment later on.

It is important to recognize, however, that the inflationary spiral can never go very far without additions to the money supply, because as prices, wages and costs rise more and more money is needed to finance transactions. More intensive use can be made of existing money, but there seem to be limits

to this expedient. Fundamentally, without an increasing money supply the feed-back, spiral effect of inflation cannot go very far.

Now, you know that the money supply increases mainly as a result of increases in bank loans and investments. In turn, any increase in bank loans and investments in this country has to be based on increases in bank reserves. The primary job of the Federal Reserve is to regulate the supply, cost and availability of bank reserves and thereby to influence the volume of money and credit in the economy. Money and credit policy thus works through its effects on the availability, cost and supply of credit and thus affects lenders and borrowers. It goes beyond this and affects the total supply of money and credit. And finally, its effects are reflected in spending and saving decisions of individuals and businesses.

Right here I think we can say something about interest rates. To get some perspective on this point let's go back a few years in time for our comparisons and look at a few representative rate figures. You will recall that back in March 1951 the Federal Reserve-Treasury accord resulted in Federal stopping its support operations in the government security market. At that time Treasury bills sold at about 1.4 percent, long-term governments were just under 2 1/2 percent, triple A corporates were about 2 3/4 percent, and the big city bank prime rate was 2 1/2 percent.

While there have been changes both up and down since that date, the current rate picture is about as follows: Treasury bills over 3 percent, long-term governments about 3 1/4 percent, triple A corporates just under 3 3/4 percent, and the prime rate 4 percent.

Now, I want to make just three points about these changes. First, Federal Reserve policy has not aimed at any given level of interest rates. The current rate pattern is a result of policy and not policy itself. I'll say a little more about this later, but the point here is that the rate increase

reflects demand and supply relationships in the money markets. Supply has risen but demand has risen faster and rates have moved up.

Second, higher interest rates do deter some potential borrowers from borrowing. These are the marginal cases, of course. While interest cost is generally a small cost factor on short-term loans, it is a bigger factor on long-term borrowings and some businesses and individuals find that their marginal projects are simply not profitable under higher interest costs. These are relatively few, as they should be.

Third, lenders are affected strongly by rising interest costs because such rate changes affect the values of existing securities. You all know that prices move opposite to yields. Thus when rates rise because credit demand increases, lenders have to make some decisions about selling portfolio securities to meet new loan demand or buy different securities. What they do depends on the relative position, of course, but they don't automatically ditch portfolio at a loss just to make new loans or investments at higher rates. They look at the whole picture and may decide to hold back on new loans and investments - in other words, they begin to screen credits.

A general tightening or easing of credit affects lenders in all sectors of the credit market, from short-term to long-term. The major suppliers of short and intermediate term funds are the commercial banks whose loan and investment expansion or contraction tends to expand or contract the volume of money. The supply of bank credit varies with bank reserve positions which are influenced by monetary policy. Other lenders also exist, however, in this sector of the money and investment market and supply funds from their cash balances. The volume of such investment varies with the attractiveness of the interest return. The total supply of short-term credit thus is very flexible, responsive to interest rate return and to actions affecting bank reserves.

the supply of long-term funds is closely related to the volume of saving. Individuals, insurance companies, savings banks, savings and loan associations, etc., operate in long-term funds. So do commercial banks through their purchases of real estate loans and long-term securities. The supply of investment funds is relatively fixed, however, and does not respond quickly to changes in demand. When demand runs high, therefore, there tends to be some spillover into the short-term credit market. We saw some of that in 1956, particularly.

Now, let us become a little more specific about monetary and credit policy and its influence on the economy and on sources of loan funds over the past year. Against the background of high level economic activity, sparked by a tremendous boom in capital expenditures for new plant and equipment, the demand for credit and capital became increasingly heavy. The volume of savings in the economy, while quite high, proved to be smaller than the demand for such savings and some of that demand spilled over into the short-term credit field, particularly into bank credit. At the same time the demand for general short-term credit also was very heavy.

The monetary authorities thus have been faced with the problem of either supplying sufficient reserves to create a credit base, which plus savings, would be adequate to meet all credit demand, or supplying something less than that amount. To supply all reserves wanted to meet all demand would have meant that the boom could have its head, probably at the price of a headache later. To supply less meant that credit would tighten.

The policy followed, designed to moderate the boom, forced the credit grantors to become somewhat more selective in their loans and investments. Interest rates rose and the values of existing assets, particularly financial assets, declined somewhat. This latter development brought about some reluctance to shift out of existing assets to obtain funds for new loans and investments,

which in turn reacted on the availability and price of credit and capital. This process tended to result in screening out less economically desirable demand in order to satisfy more economically desirable demand.

I want to underline the point that this screening process is the method under which our form of market economy determines the economic worth of ventures requiring capital and credit. The process of screening is both direct and indirect. It is direct in that certain loans are rejected outright; these are the marginal cases. It is indirect in that most loans and investments tend to cost the borrower more which causes him to re-evaluate his projects and in some cases to defer or abandon them.

It is sometimes asserted that this process involves hurting people; that all borrowers should find some source to meet all credit demand. It seems to me that this point of view overlooks completely one basic fact. The resources of this economy are not unlimited; the very nature of economic resources is that they are relatively scarce. Actually, an important part of the field of economics involves study of the efficient use of scarce resources so as to "economize" in their use. If money, which commands resources, were unlimited in amount, in theory anyone could command resources. But to put it in another and more pertinent way, if money were unlimited it would really command no resources because it would be worth little or nothing.

Let me come back to what I think is an important point here. Credit tightness is simply a result of the availability or supply of credit being reduced relative to the demand for it. It comes about either because credit supply is reduced or because it does not grow as fast as demand grows. In a boom this second development is typical. Credit conditions tend to tighten even when there is an increase in the supply of credit, as there has been, simply because the increase is less than the increase in demand. This situation is the one characteristic of the past year and a half. If credit did not tighten

during a boom, it would mean that monetary policy was not doing its job and was letting supply expand as fast as demand set by boom was expanding. In other words, it would mean that the boom itself was setting the pace, regardless of the inflationary or other unsound developments that might be occurring.

When interest rates rise, as they have risen during the past year. in a context of (1) high-level employment, (2) output pressing on limits of capacity, (3) rising costs and prices, (4) increased velocity of money, and (5) deterioration of bank liquidity and corporate working capital ratios, and when all of these developments occur at a time of continued stability and some growth in the money supply, the only real explanation is that plans for investment in the aggregate are in excess of current savings. It follows, also, in this context that money cannot cease to be tight and equilibrium be restored unless either savings increase sufficiently to meet investment demands, or investment plans are scaled down to the availability of savings, or that a balance is achieved by a combination of both.

If the Federal Reserve System should disregard its mandate and release more reserves to the member banks, this would not relieve the situation. Rather, it would accentuate it, for the commercial banks would then lend more to potential borrowers seeking loans. These borrowers, with money in hand, would enter the markets to add their bids for scarce goods and scarce services to bids already there. The effect would be to spark an inflationary spiral and to accelerate the rise in prices, wages and costs. As a consequence, even more money would be needed to finance transactions. When the circle had worked itself out, money still would be tight because the basic economic requirements had not been met, i.e., saving had not come into equilibrium with demands for investment.

Now, the Federal Reserve System has, in fact, mitigated the rise of interest rates during the past year in the sense that it has increased somewhat the volume of reserves made available to its member banks, and, to the extent that increased loans and increased spending were made possible by these releases, the System shares in some part responsibility for the price advances that have occurred. It did not release reserves in sufficient volume, however, to neutralize the economic forces that were the fundamental cause of the rise in interest rates. Throughout the past year, as a result, commercial banks have operated within a general environment of restraint that helped to temper the exuberance of the boom.

Most mortgage lenders have been influenced to some extent by tight money conditions. Most have made upward adjustments in their interest charges on farm mortgage loans, and in many cases the terms and selectivity in lending have further reinforced this trend.

Tight money conditions appear not to have affected the availability or cost of non-real-estate loans to farmers as much as in the case of farm mortgage loans. Most farm lenders appear to be meeting the credit needs of their regular farm customers for operating purposes. Those lending agencies which obtain their funds directly from the money market have probably been more sensitive to over-all changes in credit availability than lenders who obtained the bulk of their funds from local or regional sources.

Present conditions can hardly be characterized as boom conditions, of course. The economy seems to be moving generally sidewise at a very high level, a situation that is all to the good. There are some soft spots but these are, on balance, offset by strength in other areas. The outlook seems to be reasonably bright -- a bigger year than 1956 but not much bigger. Money is a little easier which reflects a relative shift in demand and supply. Supply has increased a little from savings.

Monetary policy, I believe, can take some credit in bringing about this high level stability. Obviously it cannot take all of the credit for other factors have been at work.

Perhaps I had better put one qualification into the picture at this point. You, of course, know it already but I cite it for the record. Money policy, by itself, cannot restrain inflation nor stop deflation. It can create the proper conditions but it cannot do the whole job.

This is particularly evident when we consider the "cost-push" type of inflation, for example, the familiar cycle of wage pressures, higher costs and higher prices. And this kind of development poses a major dilemma for monetary policy. Should it "underwrite" higher cost-price structures by releasing more reserves to form the base for a larger money supply? Or should it hold down growth in the money supply unless paralleled by growth in real output in the face of a possible rise in unemployment because resource use cannot be shifted quickly?

Monetary policy during the past year has avoided both horns of this dilemma only in part. It has underwritten some of the higher cost-price structure but not all of it by any means. And it has avoided rising unemployment.

In fact, it has been able to do this because we have experienced what is called rolling adjustment. This is the situation in which first one kind of demand and then another acts as the driving force in the economy while the other demands fall off, thus keeping total demand more or less equal to total capacity. The mutual interdependence of the various kinds of demand so far have not led to any cumulative downturn when one kind fell off. Thus when auto demand dropped last year, it did not set off a chain reaction. Instead, plant construction demand picked up the slack.

Can this kind of rolling adjustment continue to lead us on toward economic growth with stability? I don't know, of course, the absolute answer to that question. I hope that some of the demand that has been deferred will pop up again if other demand falters. Tight credit itself has helped defer some demand; easier credit, should it prove necessary, could translate that deferred demand into current demand, particularly state and local government construction and possibly residential construction.

I am convinced that money and credit policy should not "underwrite" the full amount of higher cost-price structure by supplying sufficient bank credit to meet all demand, both strong and weak. That way leads to outright inflation with all its evils. Rather we should move toward making free markets work as best they can by removing institutional rigidities such as legal limitations on interest rates payable on mortgages or school bonds, etc. These keep people who want schools or homes from competing for funds in free markets.

The alternative to free markets is sheltered markets - sheltered by subsidy, guarantee, or tax benefits. But again I note that resources at any given time are limited and making sheltered markets for resources limits supply for unsheltered markets. In a free society not everyone can be sheltered; if everyone is, the society is not free.