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Statement of

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The Battle Against Recession

Since my appearance before this Committee last August, the United States economy has passed from an inflationary to a recessionary phase of the business cycle. For the third time since World War II the strong growth trend in this country has been interrupted by a downturn.

The troubles now confronting us are traceable in many respects to the excesses of the preceding three-year boom with its creeping inflation overtones.

Recession as an effect of boom

Between the summer of 1954 and the summer of 1957 real output of goods and services in the United States increased about 12 per cent. But prices also rose. Consequently, the dollar value of total output, or gross national product, increased 22 per cent. This gap of 10 per cent between the real and monetary increase in total product roughly gauges the magnitude of the inflation in that period.

The three-year expansion of the economy represented at first recovery from the 1953-54 recession, sparked by active consumer buying of houses and automobiles. This surge of consumer buying, which was encouraged by the ready availability of mortgage funds and consumer instalment credit on sharply eased terms, was followed by a wave of business spending for plant and equipment that transformed the 1954-55 upswing into a boom. The classic acceleration principle of business cycle history found confirmation once more. In the process, inflationary pressures were generated as aggregate demand came to press against productive capacity. The upward price movement so generated received further impetus from the mutual interaction of prices and costs.

The current recession is a reaction to both the investment boom and the inflation which accompanied it. The growth of business capital spending beginning in early 1955 was at a rate that was unsustainable. An economy with a long-run upward growth trend of about 3 or 4 per cent per year cannot sustain for long an increase in business investment of about 10 per cent per year in real terms, such as we experienced in 1955-56. The investment spending, even if prolonged by inflationary trends, had at some point to slow down.

Throughout our economic history, investment spending has tended to come in waves, closely associated with cyclical variations in over-all economic activity. These periods of rapid growth in our capacity to produce have been followed by cutbacks in investment spending, usually with secondary effects on total incomes and output. One of the goals of stabilization policies is to attempt to mitigate the effects of such cycles without inhibiting underlying growth forces.

In the 1955-57 investment boom, inflation aggravated the tendency toward overexpansion as well as the subsequent decline. Inflation, as I have said, was the result of an excess of total demands at existing prices over what the economy was producing, and apparently able to produce under the existing organization and use of resources. But once prices started up and expectations of additional price and cost increases were engendered, spending was stimulated further. With prospective costs rising, business had every incentive to enlarge its productive capacity at today's rather than tomorrow's prices. And when investment plans are made on this basis, a certain amount of uneconomic productive capacity is likely to be created; that is to say, capacity which does not reflect a basic pattern of demands undistorted by expectations of rising prices.

Monetary policy in the boom

In cyclical processes, monetary management has a responsibility to use such powers as it possesses over economic events to dampen excesses in economic activity. If this responsibility is exercised wisely and effectively, it should help to foster a relatively steady and sustainable rate of economic growth and longer term price stability. Perfection in monetary management and economic stabilization, however diligently sought, is unattainable. Nevertheless, over the years progress has been made and further progress will be made.

Last August monetary policy was in a restrictive posture, as it had been for two years. As I stressed before this Committee at that time, the inflationary pressures that had developed in the boom had also given rise to the disturbing notion that creeping inflation had become an inevitable condition of modern economic life. This idea took nourishment from the steady upward movement in consumer prices in 1956-57 as well as from the substantial rise in all prices since prewar years. The creeping inflation idea was, in turn, conspiciously reflected in the sharp rise in prices of common stocks, the most popular hedge against inflation. Thus in July 1957, for the first time in two decades, the average dividend yield on stocks was bid below the average yield on high grade corporate bonds.

In that atmosphere, Federal Reserve discount rates were raised one-half percentage point in August in order to relate them more closely to market rates which had been rising for some time and in this way to maintain their effectiveness in restraining bank credit and monetary expansion. That action also served as an indication to the business and investment community that the Federal Reserve rejected the idea that creeping inflation was inevitable.

On the financial side, the three-year expansion under conditions of monetary restraint had reduced markedly the liquidity of the business community and of the commercial banks. The money supply had increased but little after 1955. Its velocity of circulation, however, had quickened appreciably; that is, money holdings had been lowered in relation to the growing gross national product. Indebtedness of consumers and businesses had increased relative to incomes.

Inflationary sentiment was a factor not only in the domestic economy but in other industrial economies as well. Widespread expectations had developed in world markets that failure to arrest inflation in key countries, especially in Europe, would result in important changes in international currency values. Despite actions taken by various countries over the summer to strengthen their anti-inflation programs, speculative movements of funds continued to dominate exchange markets. The crisis was not resolved until late September, after the Bank of England raised its discount rate from 5 to 7 per cent and the German Bundesbank, almost simultaneously, lowered its discount rate from 4-1/2 to 4 per cent, thereby lessening the incentive for short-term funds to move from sterling into deutschemarks. These actions made it clear that inflationary trends would be strongly resisted and that key foreign currency values would be maintained.

We are now aware that the economy was to reach a cyclical turning point in the fall. This is not to say that there were no earlier signs that the economy might be getting into an overextended position. This was shown by a fall off in new orders for machinery and equipment in the earlier months of 1957 and by the development of a margin of excess capacity in some key industries. In the spring, however, consumer buying took on renewed strength as business investment was being maintained, encouraging expectations of further economic expansion and of continued upward price pressures. Consumer buying, particularly of nondurable goods and services, rose through August. On balance, it looked as if an extension of rolling adjustments at a high level of activity would continue to be the prospect.

During the fall, expansive forces gave way and downturn set in. Business inventory holdings had been at a high level for a long period in which the price trend had been upward. Hence, they were vulnerable to the emergence either of eased conditions of supply or of relaxed market demands. This occurred as Government defense orders, which had been expanding in the spring, were cut back in the summer and fall to conform to the budget program and the ceiling on public debt. At the same time a decline in business spending for plant and equipment set in, in recognition that productive capacity had risen more rapidly than final demand and output.

Monetary policy and recession

As evidences of downturn developed the Federal Reserve System began to alter the course of its policies. In the latter part of October and early November, open market operations were used to relax somewhat pressures on commercial bank reserve positions. In mid-November, a one-half point reduction in discount rates signaled a decisive change in System policy. From this point on, restraints on bank credit expansion were progressively relaxed.

Through the first quarter of this year, as reserves were provided through open market operations and by two reductions in reserve requirements, member banks reduced their indebtedness at Reserve Banks and accumulated some excess reserves. Between September and March, member bank borrowing at the Reserve Banks declined from about $1 billion to less than $150 million, while excess reserves rose more than $100 million. Thus net reserve positions shifted by almost $1 billion. Discount rates were reduced in two further steps and at the end of the quarter stood at 2-1/4 per cent, compared with 3-1/2 per cent in the autumn.

Just last week the System took additional action to ease credit conditions. Reserve requirements were reduced further, releasing about $450 million from required reserves. Discount rates were lowered an additional 1/2 percentage point, bringing them to 1-3/4 per cent at seven Federal Reserve Banks.

The easing of bank reserve positions has been reflected in a substantial expansion in bank credit and an exceptionally sharp drop in interest rates. Over the six months ending in March, for example, the total of bank loans and investments has increased almost $5 billion. In the corresponding six-month period a year ago, the growth of bank credit was less than $1 billion. The expansion of bank credit has been mainly in the form of Government security holdings, and the effect has been to enlarge holdings of cash balances and to increase the economy's over-all liquidity. Aside from temporary spurts of bank loans to business in December and March, business loans outstanding at banks have tended to decline with economic activity. However, loans on securities which provide important support to the capital markets have risen.

As Federal Reserve policy has shifted from restraint to ease over the past six months, financial markets have reacted strongly. Short-term interest rates fell more rapidly in the three months following the first reduction in Federal Reserve discount rates than in six months following the 1953 turning point. By mid-April, Treasury bill yields, an indicator of the availability of funds in the money market, had declined to about 1-1/4 per cent, compared with more than 3-1/2 per cent in October.

Longer term market yields are down about three-fourths of a percentage point. This decline has met with remarkable demand response in the long-term security markets and the total volume of corporate, State, municipal, and foreign borrowing has reached record levels. In the first quarter of this year, State and local governments issued $2-1/4 billion of new securities. This was almost 25 per cent more than in the same period of 1957 and represented a new record high for the quarter. Corporate business raised $3.1 billion in new capital through the securities markets. Although smaller than a year ago when business investment outlays were still rising, this volume of flotations exceeded that of any other first quarter on record. New issues of foreign and international borrowers amounted to an estimated $360 million, twice as much as in the first quarter of 1957.

It should be stressed that the Federal Reserve has been pursuing an active, not a static, policy and using all its instruments in the process, as indicated by the attached record of policy actions since last fall. Banks have been expanding their assets and deposits. Their reserve needs have increased, requiring that their reserve positions be strengthened. This has been done by means of open market purchases, lower discount rates, and reductions in reserve requirements.

Thus, monetary policy has contributed to an increase in the availability and a reduction in the cost of borrowed funds. This has permitted a sizable expansion in bank deposits. In this way monetary policy is helping to increase the liquidity of the economy, which is an essential financial prerequisite to recovery and renewed economic growth.

The problem of public policy

No one can predict with certainty the course of the present recession. It is already deeper than the two which preceded it. Nevertheless, experience over the long history of the United States supports the belief that, except for occasional cyclical readjustments, our economy is one of continuing long-run growth and strength. Hence, governmental measures to deal with such cyclical readjustments ought to be shaped so as to be consistent also with the longer run trend.

This is not a prescription for inaction or immobility at times of recession. It is, rather, a recommendation for discretion and flexibility in selecting and implementing stabilization policies so that measures undertaken to deal with today's problem do not aggravate those of tomorrow. At the same time, public policy needs to keep alert to any tendency for downward movements to become cumulative.

A second observation relates to the use of resources. As I have said earlier, a part of our present problem stems from overexpansion or misdirection of investment in particular lines of industry. In some cases, excess capacity exists in part because producers have misjudged the market or the long-run rate of growth of demand for their products. To some degree, this is inevitable in a free market economy. It can be mitigated, however, to the extent the Government is able to stabilize aggregate demand around a steady growth curve and thus to provide a general economic climate that facilitates shifts in resource utilization as these are dictated by free markets.

The human problem

In discussing economic problems, we should never forget that what we are really dealing with are human problems--human problems of a very important kind. In combatting inflation and deflation, what we are really doing is combatting human misery that springs from economic causes.

Every recession is serious: this one and all the others that preceded it. The best time to recognize that fact is before a recession starts, for the best way to prevent a recession is to forestall the inflation that precedes it. When the next economic turn comes, as assuredly it will, let us try harder to remember that--and act accordingly.

Today we are concerned, and properly so, with fostering the recovery everyone wants from a recession that nobody wants. That's fine. But let's also keep in mind that, vital as it is to achieve recovery, it is also vital to insure that it will be a recovery that lasts; a recovery that does not merely provide ephemeral jobs, but lasting jobs.

We must recognize that enduring prosperity is not a question simply of the dollar volume of spending. It is also a matter of equilibrium and balance of costs and prices within the economy. Lasting prosperity rests upon the efficient production and distribution of goods and services at prices that people are willing and able to pay. It has to be earned. It can't be provided as a gift, by the Government or anyone else.

Concluding observations

By fostering conditions conducive to prosperity, the Government can help a lot. But it can't do it all. That is why the Employment Act of 1946 pledges the Government's efforts to create and maintain "conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing and seeking to work." And it is why the same Act says the Government's efforts to that end shall be applied "in a manner calculated to foster free competitive enterprise and the general welfare."

Monetary policy is undertaking, within its inherent limitations, to provide such a climate for recovery. It is not omnipotent, but I can assure you that the System is approaching the problem of combatting recession with just as much vigor as it exhibited in battling inflation. On both the up and the down side of the business cycle, the System is striving constantly to promote economic stability and growth.

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PRINCIPAL POLICY ACTIONS OF FEDERAL RESERVE SYSTEM,
MID-OCTOBER 1957 TO MID-APRIL 1958

Date	Action	Purpose of Action
57--Mid-Oct.-Dec.	System holdings of U. S. Government securities increased by $1 billion, including substantial amounts of securities held under repurchase agreement. Member bank borrowings declined from an average of about $1 billion to an average of less than $750 million.	To increase the availability of bank reserves for seasonal purposes and also to cushion adjustments and mitigate recessionary tendencies in the economy.
57--Nov.-Dec.	Reduced discount rates from 3-1/2 to 3 per cent at all Reserve Banks.	To reduce the cost of borrowing from the Reserve Banks and eliminate any undue restraint on bank borrowing in view of the decline in business activity and evidences of economic recession.
58--Jan.	Limited net reduction in holdings of U. S. Government securities to $900 million, more than half of which represented securities held under repurchase agreement at end of year. Member bank borrowings declined to an average of $450 million.	To ease reserve positions by absorbing only part of the reserves made available by the seasonal return flow of currency from circulation.
58--Jan.	Reduced margin requirements on loans for purchasing or carrying listed securities from 70 to 50 per cent of market value of securities.	Stock prices and the volume of credit in the stock market had declined to levels near or below those prevailing at the time of the previous increase in requirements.

Date	Action	Purpose of Action
958--Jan.-Feb.	Reduced discount rates from 3 to 2-3/4 per cent at 11 Reserve Banks.	
958--Feb.	Reduced reserve requirements on demand deposits from 20 to 19-1/2 per cent at central reserve city banks; from 18 to 17-1/2 per cent at reserve city banks; and from 12 to 11-1/2 per cent at country banks, thus freeing an estimated $500 million of reserves.	To reduce further the cost of borrowing from the Reserve Banks and increase further the availability of bank reserves in order to encourage monetary expansion conducive to resumed growth in economic activity.
958--Mar.	Reduced discount rates from 2-3/4 to 2-1/4 per cent at 11 Reserve Banks and from 3 to 2-1/4 per cent at one Reserve Bank.	
958--Mar.	Reduced reserve requirements on demand deposits from 19-1/2 to 19 per cent at central reserve city banks; from 17-1/2 to 17 per cent at reserve city banks; and from 11-1/2 to 11 per cent at country banks, thus freeing an additional $500 million of reserves.	
958--Feb.-Mid-April	Purchased about $450 million of U. S. Government securities. Member bank borrowings declined further to an average of about $180 million.	To supplement reserve requirement actions in further increasing the availability of bank reserves.
58--Apr.	Reduced reserve requirements on demand deposits from 19 to 18 per cent (in two stages) at central reserve city banks and from 17 to 16-1/2 per cent at reserve city banks, thus freeing a total of about $450 million of reserves.	To supplement previous actions to encourage monetary expansion and resumed growth in economic activity and to offset recent gold outflow.
58--Apr.	Reduced discount rates from 2-1/4 to 1-3/4 per cent at seven Reserve Banks.	