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THE WHAT, WHY AND WHEN OF FEDERAL RESERVE POLICY

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During this past year, credit has been described as "tight". The "tightness" has stemmed from sharp gains in the aggregate demand for credit rather than from a diminution in its supply. Actually, the latter has increased a little over the year ago figure and has been used more efficiently. This is evidenced by the 8 per cent increase during the year in the turnover of demand deposits. Even though it has been restrained, the supply of credit has not been reduced.

As the demand for credit has forged ahead of the supply, the influence of the resultant scarcity has been felt in both the bond and mortgage markets. In turn, it has affected residential construction and possibly school building, although the latter continues in large volume. The extent of the impact on industrial expansion is more difficult to judge, but it has been affected also.

The mounting demand has come from a variety of sources--governmental as well as private. The government has had to buy planes, ships and missiles that require many of the same materials used in the building and equipping of plants for private industry. Corporations, in turn, have competed with those individuals who desire new houses, cars, and household durables. As a result, inflationary pressures have centered largely in metals and metal products; these pressures are not confined to this country alone, but are world wide.

During this boom, the Federal Reserve Index of Industrial Production has been at or near capacity levels and there has continued a substantial expansion of plant capacity. This tremendous expansion has been superimposed upon an economy that was already using many of its resources to the full. The resultant competition for scarce materials, labor and credit has caused the prices of all of them to rise. By the end of 1956, wholesale prices had pushed above those of mid-1955 by about 5-1/2 per cent and consumer prices by about 3 per cent.

The objectives of monetary and fiscal policy.

Even though my topic is Federal Reserve policy, it would be naive to discuss the objectives of monetary policy apart from those of fiscal policy. Fiscal policy, embracing as it does, debt management, Federal budgeting, and Federal taxation, is probably as potent in helping to stabilize the economy as is monetary policy. Their objectives are two-fold:

(1) To foster orderly economic growth and sustain employment at consistently high levels;

(2) To maintain the financial equilibrium of the economy, both internal, by protecting the purchasing power of the monetary unit, and external, by keeping international payments in balance. The last of these is currently of much concern to Britishers.

Why money has been tight.

The statement of objectives may be expressed in another way: to keep the economy running at high speed without overstraining its capacity. Only thus can our nation achieve economic progress in the form of more jobs and more goods combined with a dollar of stable buying power. To do this, a continuous stream of transactions must be kept running much like the stream of traffic on a crowded highway. This highway stretches ahead as an inviting path for future generations provided the current economic traffic does not become snarled.

However, there is now pouring into the road more economic traffic than the present road capacity will permit to move forward at one time. Too many people want too many things too fast--steel, cement and labor. As a nation we are trying to buy more goods than can be produced, trying to spend more than our incomes, trying to borrow more than we save. If we should succeed, the result can only be higher prices, and . . . we would suffer inflation with its destruction of savings and its injury to those dependent on them. The latter now include not only the traditional widows and school teachers whose incomes are fixed, but the millions of wage earners and citizens building up pension rights, other fringe benefits, and life insurance equities.

To prevent inflation, we must avoid spending more than we earn through production. In a free economy, we do this by making money and credit as scarce, relatively, as the goods people want to buy with money and credit. This means that the price of money--the interest rate--goes up rather than the price of goods. Credit is allocated in the market place to those borrowers that are willing to pay the higher price of money. The weaker demands for funds are set aside and with them some of the demands for goods.

General inflation in the prices of real goods is therefore avoided by accepting instead a price rise for the money used to buy these goods. We do this through governmental supervision of the total supply of money and credit, to keep it in harmony with the economy's capacity to produce real goods.

In this country, the Congress has made the Federal Reserve trustee over the total supply of money and credit. Its obligation as trustee is to carry on its work free from partisan political pressure on the one hand or private business pressure on the other. Specifically, its role is to regulate the reserves available to commercial banks so that bank credit may contract and expand in accordance with the fluctuating needs of the economy.

At the same time the allocation of the available supply of money and credit is left to the competitive forces of the market. In this way decisions of individual borrowers and lenders stand as the basis for making the best use of the economy's resources.

Monetary instruments.

The tools used for general monetary control are the well-known three: open market operations, rediscount rates and reserve requirements. These have been listed in the order of their refinement. The first two have the delicate touch of the chisel or plane; the last, the cruder power of the broadaxe. In addition to these general controls, there are those described as selective or direct. The only one now in effect in this country is the control over stock market credit that is exercised by the Federal Reserve Board under authority from the Congress. This particular form of selective control is easy to administer because of the limited number of those affected, the self-government imposed by the Exchanges upon their members, and the self-discipline of banks and brokers in adhering to the Board's regulations.

However, during the war many nations, including our own, adopted other forms of selective control over imports, foods, and critical materials. One cannot criticize a country for resorting to such controls in emergencies, but these selective controls appear to have provided only a partial answer. Even when supported by war-time patriotism their success was limited, and in the end they did not prevent inflation. Despite the policing of the multitude of enterprises and of private citizens, the purchasing power of the monetary unit suffered eventual loss anyhow. It seems clear to me that it is not possible to stop with just a little rationing, or a little price and wage control. Once embarked upon, such governmental controls tend to spread until they cover most of the economy and most citizens.

It is little wonder, therefore, that countries began to shake off this harness of detailed control by government as soon as free markets were functioning again. Since such markets enable individuals to determine for themselves what they need and what they will buy and at what price, they give people the satisfaction of using their own knowledge, judgment and initiative. Such freedom is important even if many spending decisions be unwise. Moreover, these processes of the free market place are the only ones consistent with the private enterprise system.

Coordination and timing of monetary and fiscal policies.

Coordination of monetary policy with fiscal policy is not easy. Take the problem posed for both the Treasury and the Federal Reserve at the time the discount rate was raised in November 1955. For some months, business confidence had been mounting. It was evidenced by the rise of industrial orders and of loans, by rising stock prices, by business plant expansion, by a scarcity of steel, cement, and glass, and by increasing prices of many important industrial materials and products. Then came the economic uncertainties stemming from President Eisenhower's illness in late September. That these uncertainties dissolved in the sober reflections of businessmen seemed to be indicated when the McGraw-Hill survey of capital additions forecast an overall increase of 1956 plans over 1955 of 13 per cent. The return of ebullience plus high seasonal demand for loans caused the Federal Reserve Banks, with the approval of the Board of Governors, to raise their discount rates in November even though the Treasury faced a refunding in December of over $12 billion. The Federal Reserve action, necessary as it was, made a more difficult problem for the Treasury in refinancing its maturing obligations in December. The action had to be taken at an unpropitious time despite some risk of unsettling the market for government and private securities.

So far we have discussed coordination in terms of concerted action through maximizing the mutual assistance of monetary and fiscal policies. We turn now to another aspect of coordination: proper timing. Timing difficulties tend to hamper the effectiveness of fiscal measures as stabilizing tools more than that of monetary measures. Fiscal policies have a less direct and immediate influence than do monetary policies upon such causes of disequilibrium as inventory accumulation and the excessive use of mortgage or consumer credit. Fiscal decisions, since they are necessarily long in the making, may come at just the wrong time to improve business stability.

For monetary authorities, the most fundamental problem of timing is to foresee changes in the business climate in order to take compensatory action before the figures actually prove its necessity. Promptness of action is imperative if the anticipated results are not to be reduced unduly by the time lag between changes in monetary policy and their effect on business activity. If the authorities wait until the figures demonstrate beyond question that further credit restraint or stimulation is needed, the action may lose its effectiveness, in whole or in part. But the perils of action based on judgments in advance of confirmatory information are obvious!

Of the monetary tools, open market operations are responsive in the extreme. Buying and selling can be modified from day to day, and even from hour to hour, to adapt to fluctuations in the tightness of the money markets, and still work in the direction of economic stability. Open market operations, flowing from the instructions of the Open Market Committee, have the sensitivity of an automobile accelerator.

Discount operations are also responsive and sensitive, even though discount rate changes are only made from time to time to adjust to changes in levels of market rates. Discount rate changes signal a recognition on the part of the Reserve System that a significant change has occurred in supply-demand conditions in the credit market. Open market and discount operations are closely related functionally--so closely related in fact, that they are basically supplemental tools. Each affects the other and each reinforces the other.

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 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 often 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. When the latter 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, it reduces the number available for current consumption. 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 current 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 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. By now, these ruinously low prices have so stimulated consumption, from the low level of 55 pounds per capita in 1951 to 83 pounds last year, that prices have finally stabilized and turned upward after a most painful and costly readjustment.

If consumption is to expand, then productive facilities must first be increased. 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 or productivity are increased, additional credit will only result in the bidding up of prices. Until recently, for example, the real limit on the amount of new housing that might be built in any year depended not so much on the need for better homes, or the market demand, or even the availability of financing, but on the supply of men and materials that could be drawn into residential construction. With all the other demands for labor and building materials impinging on the market, easier financing facilities could only result, and in fact did result, in increasing building costs.

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 can only come out of current income that is not spent for consumption, because only through such saving 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 and attract the flows of money and of goods and of services into appropriate channels and to keep them moving. There are bound to be obstructions and hindrances and slowdowns from time to time.

As I mentioned earlier, the Federal Reserve is concerned primarily with total production and total incomes in the economy, and only indirectly with component parts. Orderly growth for the economy as a whole does not and cannot mean uniform rates of growth for all industries simultaneously. Improved living standards grow out of new technology and resources that generate new demands and shift production away from older industries. Among individual industries, there is a continual process of birth, growth, and decline. From this evolutionary process emerges growth in total output, in productivity, and in the standard of living. Such changes in industrial structure should be facilitated rather than obstructed so that production can grow fastest in the areas where demand is greatest. Mobility of resources is essential to a healthy economy, and to orderly economic growth.

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.

With the chance for such cumulative responses ever present, what may sustain the continuous rolling adjustments at high levels in the future? There are several possibilities. One of these consists of time lags in cumulative reactions. Take the extraordinary consumer spending of 1955 that helped to produce the 1956 rise in capital investment. If this investment boom was a response to the preceding boom in consumer spending, it was delayed until after the consumption growth had tapered off. This 1956 business investment may, in turn, have surged ahead at an unsustainable rate and now be susceptible to some slackening while consumption continues to expand.

A second stabilizing influence consists of postponable demands. These have marginal status in tight credit markets, but stand ready to absorb funds when credit eases. Recent residential construction is an example of this type of demand, partly because of the relatively fixed yields available on mortgage credit, and partly because of the sensitivity of home buyers to mortgage terms. State and local government construction is also in this category, because of its relatively high sensitivity to the cost of borrowing. Some long-time business commitments, such as those for utility expansion, may also be influenced by interest costs. In the tight credit markets of 1956 some of these weaker demands for funds were squeezed by the strong ones originating in business plant expansion. Tight money markets attracted additional funds, but these were not sufficient to meet the total demand. As a result, most of the growth in total output in 1956 flowed into business investment, which expanded at a rate that cannot be expected to persist indefinitely.

In this situation, the deferred housing and school needs, important and desirable as these needs are, stand as latent supports for the economy until such time as business investment slackens. When that time comes, it may be of critical importance that such latent demands be available. Still other developments, such as the Federal highway program or another boom in expenditures for consumer durables, may support the economy. All of these demands contribute to the reserves essential for maintaining stable growth. In brief, then, the Federal Reserve objective is to help maintain stable levels of total demand in the face of continuing fluctuations in its different segments. The total demand target is determined by the capacity of the economy and moves along a growth trend line established by the economy itself.

That we must rely on rolling adjustments among the segments of the economy to produce stability out of instability creates problems of its own. Mr. Stephen Taylor of the Board's staff has observed that although some instability within the demand structure is inevitable, the uneven competitive strength of different segments makes the variation in the total wider than may be necessary. Moreover, the turns of the wheel expose us to risks of cumulative reactions degenerating into recessions.

The solution is not to be found in supplying sufficient bank credit to meet all credit demands, both strong and weak. 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. A large step toward this end is to remove institutional rigidities, such as legal limitations on interest rates payable on mortgages and school bonds. 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.