ROLLING ADJUSTMENTS AND ORDERLY ECONOMIC GROWTH

(Remarks of C. Canby Balderston, Vice Chairman, Board of Governors of the Federal Reserve System, before the Conference of Business Economists, Statler Hotel, Washington, D. C., on February 14, 1957.)

The question I wish to raise is whether or not we are approaching a confluence of economic forces that will stop the recent and current rolling adjustments. Will forces that are nation-wide or world-wide give our economy another inflationary spurt or throw it into a tail spin? Or, may we look forward to a continuation of rolling adjustments within a framework of high resource use?

In posing this central question, I will place it in a setting provided by two other questions: First, how well has the purchasing power of the dollar been protected? Second, what is orderly economic growth?

How well has the purchasing power of the dollar been protected?

Marked changes in the purchasing power of the dollar are inconsistent with stable growth. Depreciation of the dollar by general price increases results from a situation such as that of recent months, in which demands for new goods and services exceed the ability of the economy to make them available at constant prices. The excessive upward push of prices and wages by those business and labor groups that have the economic power to enforce their demands also accentuates the process of inflation.

The record of recent years for protecting the purchasing power of the dollar has certainly not been all that can be desired. Following sharp price rises in the early postwar years and during the Korean crisis, there was a brief period of overall price stability even though there were disparate movements within the general index. After mid-1955, however, prices rose substantially. Average wholesale prices rose 6 per cent; consumer

prices, 3 per cent. The purchasing power of the dollar has thus declined during the past year and a half, and its depreciation was of a magnitude to cause us concern. Moreover, one of the best criteria of price stability is whether or not there is speculation. An excess of the latter suggests that the price movement is too great, whether the rate of price advance be large or small.

If this were our first encounter with inflation during our recent history, these developments might concern us less. But the recent changes must be added to those of 1946-48 and 1950-51. Taking the postwar period as a whole, one gains the impression of an intermittent, but relentless, depreciation of the dollar. It is this cumulative price advance of the postwar years that makes our recent price increases so disturbing. Some feel that these increases will not be offset by downward price movement, and that price rises follow a one-way street. During the moderate postwar recessions, with conditions of falling output and employment, average prices went down a little in 1949 but not at all in 1953. Consequently, price increases, even relatively moderate ones, take on a significance that they might not have if people felt they could assume that there would be offsetting declines. Even relatively small price increases begin to seem important if added on to a succession of earlier ones.

The second disturbing implication is that individuals and businesses might begin to make their decisions on the assumption that there will be a continued depreciation in the value of the dollar. Indeed, there are signs that some of them already have begun to do so. Witness the growth of wage agreements containing escalator clauses. The disastrous consequences

of a general acceptance of an assumption of continued inflation are so far-reaching as to be almost beyond calculation, Nothing could be more destructive of our hopes for growth that is stable.

What is orderly economic growth?

Perhaps the more interesting questions relate to the orderliness of growth, This concept cannot mean that each type of economic activity grows at the same rate, and at an unchanging one. A two per cent rate of growth does not necessarily mean that the output of automobiles, shirts, and bread increases precisely two per cent each year. It does not necessarily mean that business expenditures for plant and equipment grow at a steady two per cent rate, that inventories be enlarged, or rail travel increase two per cent each year. Neither does it connote that the debt of different classes of borrowers will rise at equal rates; nor that total debt will rise at precisely the same rate as output.

In an economy in which folks are free to make their own decisions about consuming and investing, and in which innovations are frequent, shifts in the composition of both spending and borrowing are bound to happen. What is needed is that total economic activity make reasonably full use of our productive resources while average prices are kept stable. This shifting composition of economic activity without unwholesome variation in the total is implied in the concept of "rolling adjustment".

A true rolling adjustment is one in which total output continues to show fairly steady, and noninflationary, growth while shifts take place in its component parts. It means a goal of reasonable but not complete stability in the general averages, and reasonably full utilization of resources. It

does not mean a perfectly steady rate of increase in output from month to month in all sectors in the economy. 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. 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.

Two types of influence are 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.

Now we come to a possible conjuncture of events. Are economic forces approaching a confluence that is of significance? One of the forces that needs to be examined, both here and abroad, is investment in plant and equipment. There seems to be evidence that such investment started to taper off in Great Britain and in Western Continental Europe in mid-1956. The topping off of new factory construction ante-dated and was independent of the weakening of the pound that began with the nationalization of the Canal. In England and Germany, this change resulted from the combined effect of monetary and fiscal policy. What was desired to check inflation finally came to pass.

In this country, industrial building also tapered off in the final half of last year. The F. W. Dodge figures for construction contracts for manufacturing buildings present an interesting trend. Whereas the first quarter of 1956 showed a 60 per cent gain over the corresponding figure for the year before, the contracts awarded during the final quarter showed a drop of 30 per cent from the year ago figure. This slowing down in the rate of growth in plant construction might lead one to question whether the increase of [illegible] per cent in capital investment in 1957 indicated by the McGraw-Hill survey of last fall ought not now to be reduced.

There are five other tendencies that should be watched with care. One is excess capacity sufficient to put a damper upon price increases in some industries and to depress prices in others. The second is consumer resistance to buying at current prices. The third, closely related, is slackening of manufacturing orders. The fourth is the reduction of manufacturing inventories if they begin to seem too large in relation to the order rate. The fifth and final tendency is one that has been apparent in this country for at least a year. I refer to the slackened pace of residential construction.

Monetary policies in recent years have been aimed at promoting orderly growth and at the same time safeguarding the value of the dollar. It may be said that, so far, growth has been reasonably orderly, whether because of appropriate monetary policy or for other reasons. Prices, after remaining moderately stable for some time, have risen in the past two years. This is a disturbing development. With little room for further overall expansion at more than a moderate pace, we may be approaching a point where the trend of events will be determined more by the balance of adjustments being made within the economic structure than by the forces of expansion that can be influenced by monetary policies.

The apparent successes scored in recent years in this and other countries by fiscal policy and by monetary policy are a cause of satisfaction. Our hope lies in so managing ourselves and our affairs as to stress the coordination and timing of fiscal and monetary actions.

In late 1953 and 1954 we went through a modest recession. Government spending for national security was cut sharply, and this was reflected

in a decreasing business outlay for new plant and equipment, as well as consumer outlays for durable goods. Inventories, which had risen during the preceding boom, also declined. This was a structural readjustment in the resources of the economy, and required that consumers and State and local governments increase their spending. Monetary policy, debt management policy, and fiscal policy were all used to foster this result. The financial climate was made favorable not only for toll road and business expansion, but also for mortgage and instalment credit. Tax rates were reduced by the Federal Government and the built-in stabilizers of unemployment aid and progressive income taxes came into play.

These moves found striking expression toward the end of 1954 and in 1955. Easy credit sparked a remarkable increase in the rate of house building. Consumers, encouraged by liberalized instalment credit, bought large numbers of 1955 automobiles, perhaps 1 million or more than they otherwise would have. Observing the renewed recovery, businessmen rebuilt their inventories, and toward the end of 1955, began a tremendous expansion of new plant and equipment.

As the cumulative forces that brought about an upturn pushed output near capacity, and as the demand for loans grew, the financial climate grew rapidly warmer. Credit, while expanding, became more expensive. This change, together with some shortages in materials, slowed down the rate of increase in expenditures for goods and services, especially those whose volume had ballooned, chiefly as a result of easy credit conditions. Its effects upon residential construction, which had risen to an extremely high level, was especially evident, partly because ceiling rates of insured and

guaranteed mortgages reduced the ability of this market to compete against other demands for funds available for lending.

More recently, the most potent expansive force has been business investment spending. Its rate has been so high as to bring its sustainability into question. The most important point is whether or not overcapacity is being created. This raises the problem of the quality of business decisions, of whether or not we have engaged in speculation in facilities rather than in stocks and inventories. If business makes decisions of inferior quality, investment may be a qualitative as well as a quantitative threat to stable growth.

What is to be done to keep this type of spending and others in line with the total resources that we have available and in some reasonable relation to one another? From whence comes the overall discipline or guidance that can direct the economy towards a course of stable growth? This is where monetary policy comes in, of course, along with other powers of Government that contribute to the cause of economic stabilization: debt management policy and fiscal policy. It is the task of both monetary and fiscal policy to help create financial conditions that are appropriate to the needs of the economy, and that will encourage businesses, individuals, and governmental units to make the kind of spending decisions that are called for by the logic of our overall economic situation.

The question with which I began is whether enough of these tendencies will bear upon the economy at the same time to bring about a significant decline in production and employment.

Does a conjuncture of events impend that would interfere with the rolling adjustment we have been experiencing and call into being forces that

would feed upon each other, thus leading to a downward spiral? Or, should we view the shifts that may be in process as no more than desirable easing of pressures that were straining our resources and causing prices to rise?

We still have huge latent demands, that have recently been unsatisfied, stemming from the great need for more roads, more schools, more housing, and greatest of all, the military requirements of our uncertain world. The immense road building program is in being and is about to roll. The voters have already approved large additional financing for state and local construction. The mortgage market is bidding avidly for any savings available. The budget now being debated with such anxiety reflects the increasing military bite upon our resources. In addition to these demands already in existence, technological advance continues to accelerate.

Stable economic growth with full employment is essentially a process of maintaining an appropriate balance between productive capacity and consumption. But neither monetary policy nor fiscal policy, nor the two in concert, can maintain economic stability if group psychology runs rampant. They cannot lift business from depression in the face of general despair; nor can they prevent inflation if business decisions lack the quality of prudence.