THE USE AND MISUSE OF CREDIT

(Remarks of C. Canby Balderston, Vice Chairman,
Board of Governors of the Federal Reserve System,
at the 6th Annual Directors Conference, Connecticut Bankers Association,
at Cheshire, Connecticut, on Wednesday, April 9, 1958.)

Monetary policy is the responsibility of the Federal Reserve System. Its central objective is to provide credit and monetary conditions that will foster sustained economic growth and at the same time protect the purchasing power of the dollar. Its operations are carried out through the commercial banking system, but they affect the whole credit market. Specifically, monetary policy increases or decreases bank reserves.

It is useful to distinguish two main questions that the Federal Reserve must consider. One is the total quantity of reserves that should be made available, for this determines the amount of credit that the banking system can create. The second question relates to the channel through which the reserves are made available.

If the System provides reserves through some positive action, such as open-market purchases of securities, "free reserves" tend to be increased. When this occurs, the money market is likely to become easier and banks to expand their outstanding credit, either through making new loans or through buying securities. As a result, interest rates tend to decline. Conversely, the reserves might be made available at the initiative of the member banks by borrowing from the Federal Reserve. When the latter permits bank reserves to be expanded only in this way, the rate of bank credit and monetary expansion tends to slow down, and credit conditions generally become tighter.

It is also important to distinguish between monetary actions designed to alter the availability of reserves to the banking system, and those designed merely to counteract purely market developments of a recurring nature that influence the supply of bank reserves. For instance, during each Christmas season, there is a substantial increase of money in circulation. This would cause a drain on bank reserves and a substantial tightening in the money market if Federal Reserve credit were not expanded to offset this outflow of currency and thus keep the money market stable.

Factors other than central bank policies, however, are the major influences affecting the availability of funds. A strong one is the amount of money that individuals and businesses are saving out of their current incomes. Also, the demand for credit varies according to whether people have a greater or lesser desire to borrow and whether or not the government is borrowing.

Changes in the rate of growth of bank credit--since bank credit is a marginal element in the total credit supply--necessarily influence interest rates. A rise in interest rates tends to curb spending financed by credit and to stimulate saving; a fall in interest rates tends to encourage spending. Thus, by guiding the growth of bank credit, general monetary policy affects the incentives to spend borrowed funds and also the incentives to save and to lend. In a real sense, the volume of bank credit is a vital balancing force in economic dynamics. And so, the Federal Reserve seeks to restrain credit growth when it increases too fast in periods of economic expansion and to encourage credit growth in the face of deflation.

Monetary policy, however, has two teammates that may work either with it or against it. One is fiscal policy--*i.e.*, governmental taxing and spending. The other is the making of economic decisions, which are influenced by group psychology. How potent is the influence of psychology upon decision making and that, in turn, upon the use and misuse of saving, spending and investment is illustrated by a comparison of the nineteen thirties and fifties. In 1934, there was a net capital inflow to this country from the rest of the world of nearly $300 million. In 1957, we sent abroad about $3 billion of our capital. In the nineteen thirties, savings tended to be in excess of investment in this country. Refugee gold was pouring in to escape the threat of Hitler's persecution and of the war that was building up on the horizon. But our nation had forgotten for the moment how to use savings constructively. Those were the days when the supposed maturity of the economy was part of our intellectual coin, and when entrepreneurs lacked the initiative and the daring to expand plant and otherwise to venture. The climate was one of pessimism that approached despair, prompted by widespread unemployment, by the loss of equities from stock market and other capital values, by inventory setbacks, and by the sacrifice of homes and farms. Men's minds were tortured by anguished recollections of what they might have salvaged had they had more foresight and greater liquidity; they were in no mood to embark on new enterprises or to manufacture new lines of product.

Compare the about-face in the present need for savings and investment here and abroad. Population growth is now 1.8 per cent a year as compared with less than 1 per cent in the nineteen thirties. The children already born will, by 1965, increase the number of teen-agers by about 50 per cent over that of ten years before. Such growth gives a strong sustaining impulse to the economy.

Then, technical advance has been accelerating. It has increased to awesome proportions man's ability to destroy himself, but it has also enhanced his ability to achieve a better material existence. Though critics may observe that this is too much an age of gadgets, technology has increased the chances of millions to enjoy comforts even beyond what was once reserved to kings. The evidences of this great advance surround us in our homes and on the roads. Whether the auto takes a disproportionate share of disposable income is a separate question, but it is certain that electric refrigeration has displaced the icebox, the iceman and the once familiar stories about him. The rapidity of change has made obsolescence a pervasive phenomenon and the price--the welcome price--of technical advance.

There may be a lesson worth learning if we analyze the current recession whose seeds were laid in the boom starting in 1955. What began as an orderly recovery from the recession of 1954 was converted by over-optimism and imprudent decision-making into a boom that was unsustainable. First, there developed a consumer boom featured by an almost unprecedented sale of houses and automobiles. In that year, we had 1 million 300 thousand housing starts and sold about 7-1/2 million new automobiles. Consumer instalment debt increased rapidly in volume as the terms of automobile paper were greatly liberalized.

In the following year, 1956, total consumer spending increased substantially further even though housing starts fell 16 per cent to 1 million 100 thousand and the number of automobiles sold dropped 20 per cent to about 6 million. A large share of the rise in debt, public and private, was accounted for by residential mortgages--this time 42 per cent of the $27 billion rise in total debt as against 29 per cent of the $45 billion rise in 1955. There was also superimposed on rising consumer spending an extraordinary expansion of plant and equipment. Such spending was 22 per cent larger than the year before. Perhaps it was prompted by the consumer boom, perhaps by the faith that demand would expand unceasingly because of population growth and technological advance. Some plants were built because of the expectation that building costs would continue to rise year after year and that the sooner the building was undertaken, the lower the total cost. In any case, confidence turned into ebullience that induced miscalculations and imprudent decision-making. The result of all this was excess capacity and cost-price dislocations. The latter have led to a profit-squeeze for some manufacturers and to price resistance on the part of some consumers.

The excesses of the boom have now brought about excess capacity relative to current demand, inventory reductions, production cutbacks, a distressing amount of unemployment, and a recession of uncertain duration and severity. Just when economic activity ceased to rise, how long it was topping off, and when it started to recede depends upon which indices are used as indicators. Common sense suggests that no one indicator alone will suffice.

The gross national product advanced sharply to a new high in the third quarter of last year, at an annual rate of $440 billion. The Federal Reserve Board's seasonally adjusted index of industrial production fluctuated within a narrow range from December 1956 until September 1957. Such important economic series as personal income, nonfarm employment, and retail sales also advanced to record levels in midsummer of 1957. Subsequently, all of these measures of economic activity declined. On the other hand, wholesale prices have not receded yet and the consumer price index has been rising to a new high with each passing month. While consumers still feel the pinch of rising prices, a substantial percentage of them suffer loss of job and of income. Even though the threat of future inflation has not been eliminated, a more pressing problem has superseded it in the shape of a cyclical recession with attendant unemployment.

And so, in October of 1957, the Federal Reserve shifted its posture to fight this new enemy. It first gave an open signal of the changed policy by reducing the discount rate on November 15. Since that time, some critics have said that the Federal Reserve was merely making motions for psychological effect, without supplying bank reserves sufficient to make credit easier. These statements have even been made by bankers in the face of the fastest decline of interest rates in history.

Now for the record of what has actually happened to monetary policy.

(1) The discount rate has been lowered three times. It is now 2-1/4 per cent, as compared with the 3-1/2 per cent rate set last summer after commercial banks, responding to strong loan demands, had moved their prime rate up to 4-1/2 per cent.

(2) Reserve requirements for demand deposits have been reduced twice. The total reduction of one per cent has released to member banks reserves of about $1 billion.

(3) Beginning in the second half of October, open market operations were used to relax the policy of restraint. The System provided sufficient reserves in relation to the demands for bank credit to permit member banks to diminish their borrowings at the Reserve Banks. By the turn of the year, the level of these borrowings had dropped below that of excess reserves; since then, it has declined further.

What has been the impact of these changes? Even though business activity has been slipping into a deepening recession, bank credit has been expanding, and borrowing in the capital markets by business corporations, by State and local governments, and by the Federal Government and its agencies has also increased. These contrasting tendencies between business and financial activity are partly attributable to the generous supply of bank reserves. Despite the reduction of business borrowing from commercial banks, the latter have expanded other types of credit by amounts that far exceeded the business loan liquidation. A true understanding of what has happened can be secured only if the customary seasonal movements are taken into account. For example, total bank deposits, including time deposits, have gained during a time of year when they usually fall.

To appraise the net effect of the shift in monetary policy accurately, one should compare the change between late November and late March with changes in the same period a year earlier. This year, during this interval, banks in leading cities <u>increased</u> their total loans and investments by about $3.7 billion whereas the year-ago total had actually <u>decreased</u> by $600 million. Although their commercial loans shrank $500 million whereas they had increased $1 billion a year ago, their holdings of securities and loans on securities grew this year by over $4-1/2 billion as compared with the year-ago drop of over $1-1/4 billion. Assuming that last year's movements represent the usual seasonal pattern, it may be said that between the end of November and the end of March total loans and investments have increased at least $4 billion more than seasonally. This represents a positive, not a grudging policy of ease.

Since the turn of the year, total time deposits at commercial banks have exhibited a spectacular gain of over $2-3/4 billion. Since the growth in deposits has taken place in time accounts rather than in demand accounts, the effect on required reserves has been small. Banks have obtained funds from the usual seasonal return flow of currency but these additions to reserves have not been offset by open market operations by the Federal Reserve. And so, free reserves this year went up by $500 million whereas a year ago they went down about $100 million.

These facts would seem to show that commercial banks have been supplied with ample reserves, which they have used not only to get out of debt, but to expand credit contrary to the usual seasonal pattern. Despite the liquidation of business loans, banks have found other uses for funds by buying securities and by making security loans. One result of the marked liberalization of credit has been the sharp decline in interest rates. The rate on Treasury bills, which responds rather sensitively to the changes in the supply of free reserves, has now returned to the level prevailing early in 1955. This is true also of rates on bankers acceptances and on commercial paper. Long-term rates, less sensitive, have also fallen but less sharply because of the continued large volume of new security flotations. Mortgage interest rates have been coming down.

In summary, it may be observed that the country's central banking system--the Federal Reserve--has supplied reserves liberally since the time when indicators showed that business activity had slipped off its high plateau and was trending downward into recession. But Federal Reserve policy alone is not adequate to curb the excesses of boom periods or to turn recession into recovery. Neither monetary policy nor fiscal policy, alone or in concert, can achieve these miracles in the face of mass psychology that creates alternating waves of unwarranted ebullience and pessimism. As Mr. Eugene Meyer, Chairman of the Board of the Washington Post-Times-Herald, observed over a third of a century ago: "Over-expansion, inevitably and always, is characterized by over-confidence and its impelling power is found in cupidity. . . . . If one could plot the curves of optimism and pessimism as exactly as one can plot the curves of prices and the volume of production and consumption, one would find that they fall considerably behind the material conditions. Only the few anticipate events; the many stop, look and listen after the event is past."

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

The economy needs a nice balance between protection and risk, between caution and daring, between liquidity and the expansion that borrowing makes possible. What is needed is neither the excessive conservatism that inhibits adventure and growth nor excessive ebullience that leads to speculation and overcommitments. In the short run, the use of resources for increasing productive capacity and for increasing the consumption of goods and services must be kept in balance. In the long run, the important consideration is to foster the highest sustainable level of growth without inflation so that productive capacity may keep up with the needs of an expanding population for both more goods and more jobs. The goal of economic growth without inflation calls for business and financial decisions of high quality. The business and governmental decisions of this year will color the business situation next year and in the years beyond. There is truth in the Chinese proverb: "All the flowers of all the tomorrows are in the seeds of today."