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MONETARY MISCONCEPTIONS

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Vice Chairman, Board of Governors of the Federal Reserve System,

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Society of Chartered Life Underwriters and
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November 6, 1958.

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Charles Dickens opens A Tale of Two Cities with some observations about the state of Europe a century and a half ago:

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, . . . it was the spring of hope, it was the winter of despair."

A similar mixture of feelings is apparent today. In recent financial economic activity, some almost ridiculous effects have been produced by the alternate ascendancy of two opposite notions--one, that inflation is going to run away with us, and the other, that it is not. Even the old silent films never provided a more absurd or pathetic spectacle than that of the man who works up such a "fear" of inflation that he puts down a bet that his "fear" will materialize, and then becomes obsessed by "fear" that it won't.

The inflationary psychosis that has recently gripped our credit and capital markets has created tough problems for both the Treasury and the Federal Reserve. It is true that the Treasury's deficit is large; in fact, its actual size has come as somewhat of a shock to the financial community. But I have a hunch that mass psychology has once more run to extremes. It may have failed to take into account the strong brakes upon inflationary price rises, especially of manufactured articles, that are provided by excess productive capacity and increased productive efficiency. If these economic forces are accompanied by realistic wage bargaining, realistic pricing that will keep our firms competitive, and the determination of our nation to turn away from deficit spending, except in dire emergencies, and to return to the paths of prudence, inflation can and will be stopped.

Although the recent recovery of production and incomes has progressed at a gratifying pace, financial markets seem to have telescoped into a few months a cyclical pattern that normally takes much longer. Since the recession low, stock prices have risen persistently, while bond prices have fallen to levels comparable to those at the crest of the last cycle. As a result, bond yields of prime corporations are now significantly higher than the yields on the stocks of these same companies. One is concerned as to whether these financial shifts are consistent with underlying economic trends, or whether the current economic expansion might be frustrated by speculative ebullience.

I should like to inject here the blunt observation that the recent sharp rise in interest rates has reflected expansion of credit demand on the one hand and reduction of supply from speculative anticipations on the other. It has not stemmed primarily from actions taken by the Federal Reserve System.

The sharp decline of interest rates last Fall, which incidentally reflected speculative anticipations, was mainly a response to expansion of credit supply initiated by steps taken by the Federal Reserve to increase bank reserves. In the past year, the Fed has not only offset a large outflow of gold from the United States, but in addition has supplied a large amount of bank reserves--in fact, enough reserves to permit a $12 billion increase of bank credit. This aggressive action accelerated expansion of the money and credit supply. Demand deposits rose at an annual rate of about 7.5 per cent and time deposits at a rate approaching 19 per cent--rates of increase greatly in excess of long-term norms. For money and credit to expand consistently with production and incomes, such rates of monetary growth had to be tempered. The Federal Reserve actions of late August and early September were directed to this end. These actions have not caused money to become tight; they have merely reduced its looseness. The System's goal of providing enough, but not too much, money for healthy recovery and growth can be attained only by a close gearing of bank credit expansion with that of the economy generally. Both for the protection of all those who live on fixed incomes, such as pensioners, and school teachers, and for the benefit of all those who must have steady employment to have satisfying lives and to support themselves and their families, we must--as indeed we can--achieve and maintain high employment without inflation.

Our most urgent domestic necessity is to protect the purchasing power of the dollar while providing widespread employment opportunities. It is a matter that different nations approach differently, depending upon their memories of recent experience. In England it is understood by the majority of citizens that British firms must remain competitive if they are to export, and that unless they do export, Britishers will not eat or, at least, not eat well. In Germany the run-away inflation of the 1920's, with its destruction of savings and of individual liberties, was impressed upon the German consciousness so deeply that the guarding of the monetary unit is now a cardinal principle of the German government. Were the mark to be endangered, the German people would be heard from, and effectively. In our own country, however, it is a long time since citizens suffered from wild inflation, and their subconscious thinking does not react to the phrase "not worth a Continental" in terms of human suffering. In the United States it is the unemployment of the 1930's that has impressed the national thinking even to this day. This means that our own country must learn from the experience of others that inflation and unemployment are both threats and that flirtation with the first does not avoid the second. Experience is a great teacher, but why is she so often late to school?

What then are the misconceptions about which Americans need to get their thinking straight? One false idea is that a little inflation is a good thing and an effective antidote to unemployment. A second notion is that inflation is inevitable and that, consequently, individuals should try to outrun it by investments that may rise in value faster than their living costs. A third error is that the fight against inflation is not one for the public generally, whereas, in fact, if every one were determined that inflation must be stopped, the public will would find expression in governmental action.

As to the first misconception that a little gradual inflation is beneficial: a little inflation, sometimes thought of as about 2 per cent a year, would double the price level in 35 years. In the long run, even the debtors, who traditionally have thought that monetary inflation makes their debt burden easier to carry, find that the disadvantages of the process far outweigh the advantages. Debtors--along with creditors, workers, and employers--large and small, all have a vital stake in stability.

Nor is inflation an effective long-range means of creating jobs and of preventing unemployment. A letter received only this week raises a question about which many people are wondering. To quote from this letter: "How can industry expand, buy machine tools and provide jobs for us millions of unemployed when you guys create tight money? - - - Haven't any of you men got the guts to stand up for an expanding money supply and abundance of credit to encourage production and help make jobs?" A blunt answer to this heart-felt query is that the mere running of the printing presses or its modern equivalent, the ballooning of bank credit, does not foster productivity improvement and higher standards of living. In other countries and even in our country, highly trained ability has been diverted to making money out of trading on inflating prices rather than out of producing goods. The rise in speculative activity does create employment to be sure but not employment that lasts or that results in more goods for all to enjoy. Eventually inflation endangers and disrupts job stability. It is in an inflationary boom that the seeds of a succeeding deflation are sown.

Acceptance of the idea of gradual, creeping inflation has another vital defect. It will not remain gradual any more than a lion cub will continue small and harmless. Once the people of a country accept the prospect of continued inflation and begin to make their business decisions in the light of that prospect, the infant cub starts to grow. It becomes an animal, not only big, but uncontrollable--a vicious lion uncaged. An inconvenient but inescapable fact of modern economic life is that phenomenon commonly referred to as the "wage-price spiral". This operates to reinforce pressures on prices caused by increased demand. In that part of the economy in which wage rates are set by bargaining between strong unions and strong corporations, the latter attempt to pass along to the public, in the form of higher prices, cost increases like those arising from wage advances in excess of increases in productivity. If successful, the resulting gain in profits is then an occasion for further wage demands, followed by still other price rises.

The strong demand for goods and services that we associate with prosperity causes wages to be raised not only in manufacturing where the increases can be offset, in part at least, by mechanization, but in the service enterprises like stores, hotels, and hospitals where there is less chance for similar offsets. As a result, what we pay for services tends to rise year by year. There has been a steady increase in the cost of repairing our cars at the garage and ourselves at the hospital.

Inflation is a process by which rising costs and prices mutually interact upon each other with a spiralling effect, provided demand is present in sufficient degree to keep the spiral moving. Otherwise, the marking up of prices in one part of the economy would be offset by the cutting of prices in others. It would appear that escalator clauses written into wage contracts of large-scale industries have caused this spiral to turn more rapidly. Such automatic wage increases are agreed to by employers for the life of a contract lasting several years. The productivity bonuses are paid whether productivity in that particular industry actually improves or not. When such contracts link wage rates to changes in the cost of living, the twisting of the spiral is made more certain and more speedy.

As to the idea that, whether good or harmless, inflation is inevitable, and that its evil effects can be escaped by outrunning it: The existence of steadily rising prices over the period since World War II has misled some people to conclude that the erosion of the dollar will not be stopped. It is argued that the price level will continue to rise because of increasing demands for public spending and because of union pressures for wage increases in excess of gains in productivity. The supposed inevitability of inflation is not only a misconception but is self-defeating. Not only do unions try to protect their members by escalator clauses, but company executives decide that if they are going to need more plant capacity they had better build at once before construction costs rise further, thus increasing the pressure on construction prices. This misconception leads individuals to seek avenues of escape, which for the great bulk of citizens is self-defeating because the overuse of any avenue of escape destroys its efficacy. Instead of striving to correct the root causes of inflation, namely, imprudence in the management of governmental and private affairs, individuals seek to hedge against it by acquiring those things that they expect will go up in price faster than do the goods and services they will be purchasing.

The notion that inflation is inevitable has sometimes induced investors to try to outrun it by buying stocks or real estate. Citizens are deluded for a while by the fact that stock prices and dividends seem to be rising as fast as their living costs. As a result the demand for equities is built up to the point where they are acquired at prices that discount future growth for years ahead. It should be obvious that even though some individuals may be lucky enough to profit by such efforts to protect their savings, the great majority will not so succeed. The greater the number that attempt to escape by the same route, the smaller the chance of success. While the majority of investors cannot outrun inflation, they can do something to protect themselves against it; that is, they can unite to fight it by demanding prudence in the management of national affairs and by exercising it in the conduct of their own. In short, they can insist that the nation not spend more than it earns through production and that their government live within its income.

What is needed is for all citizens to demand careful financial housekeeping at all levels of government from the township to the federal. Especially should those who have savings let their will be known, not in spurts but steadily. The number of savers in this country is vast, and they save in a variety of ways. There are some 75 million time and savings accounts in banks, and 22 million savings and loan share accounts. Also, about 120 million people have life insurance; 40 million own U. S. savings bonds; 10 million have shares in credit unions; and 2 million have postal savings accounts. Furthermore, about 20 million are in retirement plans, not to mention the almost universal coverage of social security. There should certainly be no lack of voices raised to defend the integrity of the dollar.

The gist of my argument has been as follows: Inflation lowers the standard of living of those dependent upon savings; if continued, it tends to lower the standard of living for wage earners as well. Over the long term the majority of people cannot outrun it by smart investment; nor can so-called gradual inflation be kept gradual. But inflation can be stopped.

In bringing inflation to heel, our nation has certain strong economic allies that tend to inhibit price rises. All over the world productive capacity has been growing and output per worker has been increasing. If the capacity to produce exceeds demand, the climate does not favor efforts to impose higher prices. Moreover, those consumers who are well stocked with durables can delay purchases if they are disenchanted with the prices asked.

How, then, can the expectation of inflation be brought to a halt? These three steps would do it: One is to keep monetary policy sound so that the money supply will match the needs of the economy. You may assume that the Federal Reserve will not abdicate its trust. The second is to bring the Federal budget into balance. To the extent that the deficit cannot be wiped out by the reduction of spending, Congress should provide promptly for additional revenues. The third is to keep business and governmental decisions prudent. If they are imprudent, saving will not be encouraged and savings, which are scarce in relation to the world's needs, will be deflected from constructive uses into speculation. If decisions are imprudent, wage determinations will not be hammered out by realistic bargaining but will reflect collusion at the expense of the customer. If decisions are imprudent, short-sighted price-setting will diminish the firm's ability to compete at home and abroad, and to contribute toward providing employment.

In short, this nation cannot violate with safety the old-fashioned maxim about living within one's income. It is my firm conviction that, once American citizens understand what is at stake, they will meet the threat of inflation as they have met other challenges in the past. Kenneth Boulding, the economist, makes the sage comment: "Without the heroic, man has no meaning; without the economic, he has no sense.