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ROLLING PROSPERITY

Remarks of C. Canby Balderston,

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What should our economy be doing, and for whom?

The generation now growing up is going to need job opportunities in greatly increased numbers after 1964,---almost half again as many as during this year. By that time the number attaining the age of 18 will increase markedly because of war-time births. Moreover, wage earners of the present and their wives will continue to need steady jobs and security of savings. The average wife will need these savings even more than her husband for, having married at an age younger than he and having a longer life expectancy, she will outlive him by about eight years.

Fortunately, individuals are saving, though not fast enough to satisfy the world's desire to invest. The interest received by individuals and non-profit institutions is 2.5 times as large as the interest they pay out. For the sake of the millions who rely upon these savings, it is mystifying that more national leaders do not dedicate their talents to protecting the integrity of the dollar. Moreover, savings are needed to undergird technological advance. Upon these two, savings and technology, our country must depend to achieve a still higher scale of living, to help it compete in world markets, and to provide more jobs and more dependable ones. The attainment of these objectives requires teamwork by a triumvirate: sound fiscal policy; sound monetary policy; and prudent business decisions.

I will not discuss fiscal policy except to observe that a Federal budget in reasonable balance over the business cycle is needed to give private borrowers sufficient access to capital markets. In addition, it helps to retain confidence in the dollar by investors, here and abroad. The central banks of the world have been keeping their reserves in dollars as well as in gold, but the continuation of such trust requires that most of the time our nation live within its income as one aspect of financial management of convincing quality.

The second member of the triumvirate, monetary policy, has been delegated by the Congress to the Federal Reserve System. Such policy is an essential means of keeping the nation's total money demand, to use Clay J. Anderson's phrase, in balance with its capacity to produce. The effect of flexible monetary policy is contra-cyclical in that it contributes to the orderly growth of business and to the stability of the general level of prices. The prices of individual commodities will move up and down around this general level as they guide resources into the uses most desired. What has been bad in recent years has been the tendency of so many prices to move only in one direction that people got the idea an upward price drift was inevitable. Although monetary policy alone cannot provide financial equilibrium in the face of large deficit spending, it does help to provide the climate in which booms and busts become less violent. When total demand presses so hard upon scarce resources as to push prices upward, monetary policy restricts credit expansion. When total demand leaves substantial resources unused, it fosters credit expansion as a stimulant to business.

I will postpone the discussion of decision making and turn to some recent changes in the business cycle. This cycle is not a homogeneous thing, but a composite of many cycles; some moving up and some down. For example, the consumption of electricity has been advancing, while farm prices and incomes have been tending downward. It is scarcely necessary to remind you that the business upturn that began about two years ago caused certain indicators to climb to all-time peaks. These include gross national product, net disposable income, and the Federal Reserve index of industrial production. Throughout the post-war period, some sectors have usually been expanding to offset declines in other sectors. Such is the nature of rolling prosperity. But there are ever-present forces that threaten business stability when it is at high levels. The most prominent are fluctuations in inventories and in plant construction, changes in the rate at which consumer instalment and mortgage debt is incurred, the pricing policies of business as well as the wage demands of labor, and variations in profits. Of these, I will discuss only the first two.

In the 1957-58 recession, business inventories that had been accumulating at the annual rate of $2.7 billion were, by the first quarter of 1958, being liquidated at the annual rate of $6.9 billion. Hence, the turn-around from accumulation to decumulation was $9.6 billion. Between that low point and the second quarter of 1959, which preceded the steel strike, there was a turn-around in the opposite direction of $17.6 billion. After the rate of accumulation had reached a peak of $10.7 billion, the strike caused inventories to diminish during the third quarter of 1959 at an annual rate of $1 billion, making a down turn of nearly $12 billion. Once the steel strike was settled, inventories began to mount again, with a resultant stimulus to the economy.

Whether or not inventories are too high at any moment turns in large part upon how fast they are accumulating in relation to the rate of sales. A given inventory level may suddenly appear disturbingly large once sales volume starts to decline, or to level out, or even to increase at a slower rate. In fact the momentum of the shipments that accompany a high rate of production tends to pile up inventories after sales begin to slacken.

Plant expansion, too, has long been looked upon as a destabilizer because of its volatility. Following the consumer boom of 1955, for example, the expectations of population growth, together with the prospect of higher construction costs, caused some companies to build more capacity than they needed. Plant construction in 1956 was 22 per cent higher than that of the previous year. Such a building binge has frequently led to an agonizing reappraisal of the amount of capacity in a given industry relative to the demand for its products. Such appraisals of capacity at home and abroad have been evident not only in the short-term recession of 1957-8, but since. It will be interesting to observe the impact upon future expansion decisions of the awareness of the capacity that now exists.

Some Economic Misconceptions

Our country is plagued at times with the "free lunch" illusion. Notions that there is an easy solution to every hard problem have too vital an influence upon our future for them to be innocuous. They undermine the will of citizens and their representatives to make the hard decisions required if our government is to live within its means. As

Boulding has said: "Without the heroic, man has no meaning; without the economic, he has no sense."

One misconception is that creeping inflation is the necessary alternative to unemployment. Experience teaches that the contrary is true: that good jobs depend upon good dollars. Over the long pull, price stability does not inhibit economic growth, it encourages that growth.

Another fallacy concerns interest rates. There are those who contend that because rising interest rates add to costs, they are a cause of inflation, whereas in fact they are a product of it. Those preaching this doctrine ignore the smallness of interest payments relative to total costs. For state governments the gross percentage is only 1.4 per cent, while interest is received by state pension and sinking funds in an amount about two-thirds as large as the gross interest paid. For municipalities, the gross interest percentage to total costs is 3.3 per cent. Clearly, what these governmental units suffer from is rising cost of items other than borrowed money. If interest rates had been kept down in the face of rising demand by printing currency or by creating deposit money, state and municipal salaries and other costs would have risen still faster. During the past decade inflation has doubled the cost of services and construction that states and cities have provided. Consequently, the amounts they borrowed increased also, with a resultant rise in the amount of interest paid.

Then there are those who attribute to the Federal Reserve the purpose of making interest rates high. Actually the System desires the lowest interest rates compatible with an adequate rate of saving and with a sound dollar. "Federal Reserve operations to release or absorb bank reserves unquestionably influence short-term and also long-term interest rates, but the extent of this influence is easily exaggerated. Monetary policy is effective only so long as it works in general consonance with the economic realities underlying the situation. These realities include the basic demands for funds, whether to meet seasonal needs, other short-run needs, or for capital formation, and the basic supply of funds through saving. Federal Reserve actions cannot for long enforce rates of interest on the market that are either above or below the rates that maintain a balance between saving and investment.

"Changes in the rate of monetary growth can represent only a very small part of the total flow of funds through credit markets. If the rate of monetary growth were raised with the specific objective of adding to the supply of funds in an attempt to keep interest rates down, the additional dollars in the spending stream would certainly work to raise average prices. The process of monetary inflation is widely understood by both savers and borrowers. Such action would generate expectations of further inflation on the part of both groups. The incentives of the market place, present and prospective, would unquestionably tend to increase borrowing and discourage saving and in all likelihood rates would increase.

"In the longer run, the way that monetary policy can contribute to a lower level of interest rates is through its role in maintaining a stable value for the dollar." 1/

1/ Testimony before the Joint Economic Committee by Chairman Martin on behalf of the Board of Governors of the Federal Reserve System on February 2, 1960.

The efficient flow of funds from savers to borrowers directly and through intermediaries does not come about without a price. This price, the rate of interest, represents a penalty to those who use some one else's money and a reward to those who save and risk their funds in loans and investments. In our own country this price has been driven to the highest level in three decades because of the pressure of the demand for funds. Last year there was a large deficit in the Federal budget requiring the Treasury to borrow funds from the public at a rate exceeding all peacetime records. State and local governments continued to borrow in near-record volume. Residential construction called for large mortgage financing. All of these, plus the usual business needs, competed for borrowings and drove interest rates upward.

And so, in the year 1959, total credit expanded by $60 billion. This figure was greater than the previous peacetime record of 1958. Mortgage debt, most of it for housing, increased by $19 billion,—a record. Consumer credit outstanding rose about $6.5 billion, equalling the 1955 peak.

In appraising the results of last year, the facilitating roles of banking and of the Federal securities market stand out clearly. Commercial banks served mainly as intermediaries rather than as creators of new money. They obtained funds from savers in exchange for investment securities and then passed these funds on to borrowers. This flow from savers to banks to borrowers enabled the need for credit to be met without a dangerous increase in the money supply. The commercial banks did expand their loans, in fact by a record amount of almost $12 billion, but they raised most of these funds by selling Government securities from their portfolios to the non-bank public. The Federal securities market also played a greater role than in other recent years by facilitating the net borrowing of $11 billion by the Treasury and the selling of about $8 billion of Government securities by banks. Such an accomplishment is evidence of the responsiveness of non-bank investors to attractive rates of interest.

Decision making of high quality

So much for the role played by fiscal and monetary policy in creating a healthy business climate. But these two alone are not enough. As I observed at the outset, a third and essential member of the triumvirate is sound private decision making. Steady consistent progress calls for decisions of the best quality that business executives and union officers can make. Their decisions, if sound, will do much to lengthen the period of prosperity that the country is now enjoying. "A business situation is no better than the quality of decisions that businessmen make," Dr. Winfield Riefler once remarked to me.

The quality of business decisions is important at all times, but especially so during prosperity. In short, the duration of the current expansion will be influenced by the quality of decisions now being made by business executives. I am talking about the heads of manufacturing, mining and commercial enterprises, about farm managers and bankers--and about union officials, too. Unless their decisions reflect prudent judgment as well as a reasonably well-founded appraisal of present and future trends, executives, as well as workers and investors, will pay the penalty.

The problem, of course, is how to balance insufficient protection against too much; to achieve a proper compromise between caution and enterprise, between the safety of a strong cash position and the growth that borrowing makes possible. Proper balance requires that we not be overly cautious when times are bad, nor overly optimistic to the point of imprudence, when they are good; executives should risk neither too little nor too much, be willing to venture but still guard against unwarranted optimism.

At this point I would like to remind you of the case for decentralized decision making. It is timely that this issue be debated because some of those who urge Government to overspend its income in order to supply gaps in the material well-being of the country also suggest curbing any resulting inflation by means of additional controls. Such controls embrace the rationing of scarce materials and goods; price, credit and capital controls; governmental wage setting; and even the assignment of people to jobs. In the past, it has not proven feasible to stop with just one of these controls alone. They are interrelated. I do not believe such a control harness, outside of wartime, is compatible either with the economic freedoms we cherish, or with initiative and efficiency over the long pull.

When centralized decisions are in error, the errors are big ones. Lord Keynes observed that "a democratic approach to public problems must stress the fact that economic totals are only aggregates of millions of parts which may differ from each other in more respects than they parallel each other. Mistakes made by individuals may offset each other but mistakes based on totals are likely to be aggregative and may be disastrous. It has been said about Nazi Germany that it was so well organized that it could only make major blunders. Unfortunately this danger is not confined to totalitarian states." 2/

The economic freedoms that Americans cherish are part of freedom of enterprise. The latter embraces freedom of choice in the securing of credit, in the selection of what one wishes to buy, and in the seeking of jobs. The preservation of these freedoms, infinitely precious to all citizens, is a particular responsibility of those in the banking community.

To summarize what I have been trying to say about business decision making, its decentralization ought to be defended stoutly. The burden of proof should be placed upon advocates of national planning whenever they suggest that decentralized decision making be replaced by centralized determination by the government. Some central policy making there must be, of course. One example is dealings with other nations; another is the regulation of the <u>total</u> supply of bank credit, for as Walter Bagehot pointed out almost a century ago in his classic description of the British money market, "money will not manage itself." But, in general, experience suggests that the <u>allocation</u> of credit, the negotiation of wages, and the setting of selling prices should be decentralized. The making of these business decisions calls for self-discipline and sound judgment. As Chairman Martin has said "The state of the nation tomorrow--its progress and prosperity--rests with the decisions of today."

2/ E. A. Goldenweiser, Monetary Management (New York: McGraw-Hill Book Company, Inc., 1949), pp. 2-3.