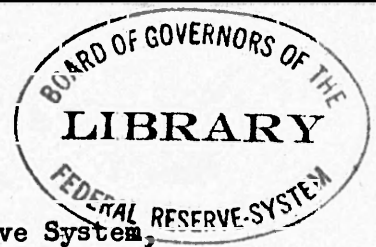


THE WHAT, WHY AND WHEN OF MONETARY POLICY



Remarks of C. Canby Balderston,  
Vice Chairman, Board of Governors of the Federal Reserve System,  
Before the Industrial College of the Armed Forces,  
on Tuesday, February 7, 1961.

The goal of fiscal and monetary policy is 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. For Americans, this highway stretches ahead as an inviting path for future generations provided the economic traffic does not become snarled.

More specifically, fiscal and monetary objectives are two-fold:

- (1) To foster orderly economic growth and to sustain employment;
- (2) To maintain the financial equilibrium of the economy--both internally, by protecting the purchasing power of the monetary unit, and externally, by keeping international payments in balance.

One of the nation's most pressing domestic problems is to achieve growth without inflation. It seeks the former, not only for security in a turbulent world, but to provide job opportunities. These will be needed in greatly increased numbers after 1964,--<sup>about</sup> almost half again as many as during <sup>part</sup> ~~this~~ years. The prevention of inflation, which means protecting the integrity of the dollar, is important if savers and those dependent upon savings are to be protected. After all, the interest-bearing assets of individuals and non-profit institutions are 2-1/2 times as great as the debts on which they pay interest. Moreover, savings are needed to undergird technological advance. Upon these two, savings and technology, our country must depend to achieve security and a still higher scale of living,

FEB 23  
1961

71853

to compete in world markets, and to provide more jobs and more dependable ones. The attainment of these goals requires teamwork by a triumvirate: sound fiscal policy; sound monetary policy; and prudent business decisions.

#### Fiscal policy

Fiscal policy embraces debt management, federal spending and taxing. It is probably as potent in helping to stabilize the economy as is monetary policy, but its implementation is made difficult by problems of timing. Its impact seems to be so delayed as to zig when it should zag, as I will illustrate later.

It also should be noted that federal budgets need to be in reasonable balance over the business cycle to give private borrowers sufficient access to capital markets. Such budgets help 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 our nation live within its income most of the time as one aspect of financial management of convincing quality.

#### Monetary policy

The Federal Reserve has been made trustee by Congress over the total supply of money and bank credit. 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, unless Congress intervenes with appropriations or guarantees. Thus decisions of individual borrowers and lenders stand as the chief basis for making the best use of the economy's resources.

Monetary policy is an essential means of keeping the nation's total money demand 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 move up and down around this general level as they guide resources into the uses most desired.

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 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 such spending 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.

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 effects, since they are necessarily long in the making, may come at just the wrong time to improve business stability.

For example, the Congressional appropriations of 1958, whose effects were intended to be contra-cyclical, actually accentuated the boom in the private sector of the economy a year later, even though the anticipation of Federal spending may have shortened the decline that came to an end in April, 1958. Moreover, this governmental spending in excess of receipts forced the Treasury to borrow \$11 billion (net) in the capital markets during 1959. This competition for savings with private industry, and with state and municipal governments, forced interest rates to peak levels in the Fall of 1959. The magic 5's issued by the Treasury at that time record the high level to which interest rates were pushed. In 1959, U. S. interest rates rose to the highest level in three decades because of the pressure of the demand for funds. The efficient flow of funds from savers to borrowers, directly and through intermediaries, does not come about without a price. This price, i.e., the rate of interest, represents a penalty to those who use someone else's money and a reward to those who save and risk their funds in loans and investments.

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. Last year's shift from credit restraint to ease began some months before the month of May which is now being identified as the probable peak. But the perils of action based on judgments in advance of confirmatory information are obvious!

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 has 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, and the uses and prices of critical materials, and labor. 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 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.

So much for the roles played by fiscal and monetary policy in creating a healthy business climate. But these two alone are not enough: a third and essential member of the triumvirate is private decision making. Steady consistent progress calls for decisions of the best quality that business executives and union officers can make. A business situation is no better than the quality of their decisions.

At this point, I would like to remind you of the case for keeping decision making decentralized. 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." 1/

Experience suggests that the allocation 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. 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:

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

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

Of the economic problems that press upon us at the moment, there are three that deserve mention:

(1) The emergence of excess productive capacity here and abroad.

One result has been to make businessmen less inclined to build up inventories now that goods are readily available on short notice. A second result is downward pressure upon prices, especially of physical goods, and the consequent brake upon inflation. What has been bad in recent years has been the tendency of so many prices to move in one direction only that people got the idea an upward price drift was inevitable.

(2) Unemployment, present and potential.

Recovery from the recession of 1958 did not restore jobs to many who desired them, especially among the unskilled and the younger workers. There still remain islands of structural unemployment as in Detroit and the coal regions. Now the onset of recession has caused the percentage of the civilian labor force who are unemployed to equal the 1958 peak. Especially serious is the plight of the blue-collar workers for whom the number of job opportunities has been shrinking.

(3) Our country's balance of payments remains adverse despite an appreciable gain in exports.

This gain, fostered by boom conditions in Europe, is still not sufficient to offset the outflow of private capital to other countries, plus the loans, grants, and military expenditures abroad. Our country has had an adverse balance of payments in each year since 1950, except for the one year, 1957. During each of the last three years, the red figure has approximated \$3-1/2 billion. In some years the accumulation of foreign

claims upon our liquid dollar assets led to the heavy outflow of gold, as in 1958, when the figure reached \$2.3 billion. At other times the continued accumulation of foreign claims did not cause as much gold to flow. This was the case during 1959 and the first half of 1960. In recent months, however, speculation that led to gold hoarding by individuals combined with some conversion by central banks of dollars into gold has caused U. S. gold to be lost at a disturbing rate. Fortunately, our exports have been exceeding our imports by a healthy margin, thanks to the boom in Europe, but this favorable balance in our current accounts has not been sufficient to offset the outflow of private capital that has resulted from American investment abroad, from the borrowing of short term funds in our country induced by the differential in interest rates, the withdrawal of equity money as foreign stock markets became more attractive than our own, and from an unusually large amount of unrecorded transactions, the interpretation of which must be based on guesswork.

And so, as one surveys the current scene he is reminded of Charles Dickens' description of Europe at the end of the eighteenth century: "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."