

FLEXIBLE MONETARY POLICY FOR STABLE GROWTH

(Remarks of C. Canby Balderston, Vice Chairman,
Board of Governors of the Federal Reserve System,
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It will not be necessary to speak of the benefits of economic growth nor of its costs: encouraging economic growth is an accepted goal of public policy; all shades of opinion favor it. Yet the more we learn about the process of economic growth, the clearer it becomes that this process is extraordinarily complex. The rate of growth we actually achieve is the outcome not as much of governmental fiscal or monetary and credit policies as it is of business policies toward prices and wages, toward research and development, and toward other forms of investment. Business decisions to introduce new products and processes, to lower prices, and to expand production in the face of uncertain markets, provide the chief dynamic element in the growth process. In addition to policies of organized groups, personal attitudes toward work and leisure, and toward consumption and saving are also extremely important in shaping the contours of the growth process.

Neither in the United States nor elsewhere has the business cycle been abolished. In fact, one might question whether it can be eliminated without retarding long-run progress and growth, not to mention individual liberty. But we have certainly learned more of its characteristics and how to lessen its impact on workers, consumers, and investors. A flexible tax system, contracyclical timing of certain public expenditures, better measurement of business conditions and better understanding of characteristic features of the business cycle have all contributed their

share to dampening the amplitude of cyclical swings. Flexible monetary policy has done its bit also. It is of its contribution that I speak.

It is appropriate to begin with the long sweep of history as did Carl Snyder in his 1927 book on Business Cycles and Business Measurements. He examined numerous time series on physical production of commodities over a long span of years, and concluded that "the growth factor has shown an amazing persistence; it has not usually been deflected by wars, panics, or other disasters; but these disturbances have been measurable as interruptions to, or deviations from the line of growth". A recent study of the Committee for Economic Development shows that from 1925 through 1957 our national product, measured in constant dollars, grew 3 per cent per annum on the average. This historical evidence covering long periods may encourage those who feel that the economy can do still better, because the rates for some shorter periods within the larger span were well above the trend line. Instead of assuming that neither government nor business policies make much difference to the pace at which our economy expands, one might conclude from the occasionally wide variations from the trend line that current policies do matter,--especially if they encourage saving and investment, or influence how close actual output will be to the potential capacity of our productive system.

Certain economists maintain that growth should be measured by the rate at which capacity is enlarged rather than by its rate of use in order to avoid short-term output comparisons that are misleading. If broad measures of national productive capacity were available, this measure of economic growth might be preferable to actual production; but lacking enough

physical measures of capacity, we must rely instead on national product in constant prices. But this measure, broad as it is, does not allow fully for new products and for the continual improvement of the quality of old ones. Quality may rank with quantity in appraising changes in both productivity and prices. Moreover, the creation of capacity to produce what people do not want may deter growth.

Now for the impact of monetary policy upon growth. Some of the fundamental improvements made over the years get overlooked. More than 50 years ago, in 1907, we experienced a business recession. It was both sharp and serious. The impact of liquidation upon the non-resilient credit system of that day produced a financial panic in October of that year. Banks suspended specie payments and the supply of money could not be expanded. This panic convinced people that an elastic currency and credit system was needed. The final outcome was the passage of the Federal Reserve Act in 1913. When President Woodrow Wilson signed that Act, he remarked that "the men who have fought for this measure have fought nobody. They have simply fought for those accommodations which are going to secure us in prosperity and in peace."

As you are undoubtedly aware, monetary policy works in the main by varying the reserve funds of commercial banks and thereby affects the ability of these banks to make money available by expanding their loans and investments. One of the principal methods is through purchases and sales of government securities. When the Fed buys governments, it supplies banks with additional reserves and thus enables them to lend more; when it sells governments, it extinguishes bank reserves and thus limits bank loans and investments. It supplies bank reserves both to meet seasonal

needs of business and to encourage the lending necessary for growth. It is important and relevant to this discussion that expansion of the money and credit supply be in conformance with growth of the economy and the constructive needs for money. But it cannot, without inflationary result, augment the creation of credit money unduly. Only if a proper balance is maintained between saving and consumption will we be able to finance technological change without inflation and secure the growth so devoutly desired for job opportunities and national well-being.

As a contracyclical weapon in the arsenal of government policies, the two great advantages of monetary policy are the speed and the delicacy with which it can be adjusted to continually changing conditions. The most delicate of central bank instruments is open market operations. These are under the direction of a committee on which all sections of the country are represented and which meets at three-week intervals. Its decisions are taken against a broad and precise background of current economic intelligence concerning business conditions, not only nationally but regionally. Each Federal Reserve Bank has a research staff as does the Board of Governors in Washington. The result is a broadly based economic intelligence system.

In timing the changes in monetary policy, the Fed acts in accordance with its best collective judgment as to the emerging current situation; it does not wait until all the business indicators show a downtrend before supplying bank reserves more liberally, nor does it wait until inflation is an accomplished fact before limiting credit expansion. It should be noted also that there are numerous degrees of monetary and credit restriction and

ease. Sometimes bank reserves are increased just a little; sometimes they are increased on a broader scale--depending on the business situation and outlook.

Monetary policy has its effects partly through interest rates and partly through the ease with which credit is available. It influences but by no means determines the level and the structure of interest rates. Our U. S. credit and capital markets are large and interconnected. The flows of funds into and through these markets from savings into investment are complex and variable. Our critics tell us we are not always correct either in timing or in the magnitude of our operations. Robert Bangs of the Board's staff observes that, like the owl in the childhood poem, we "reward each fault finding critic, with a glance analytic." Thus, we attempt to appraise objectively our performance. It is my judgment that, on balance, we do help to moderate business fluctuations and to contribute to the sustainability of growth.

As monetary policy functions continuously, changes in it are generally gradual. Reserves are either being supplied or withdrawn all the time to meet seasonal and other recurrent needs. While monetary policy can be changed very quickly, and can be applied with as much or as little delicacy as the situation seems to require, its effects are not instantaneous. They require time to spread through the banking structure and to influence lenders and borrowers in the direction desired. Therefore, in taking contracyclical actions, we must look not only at the immediate state of business, but also consider what the course of the economy may be over the next several months.

A point that should be stressed here is that monetary policy is a limited instrument. It cannot work wonders unaided by fiscal policy and by appropriate business decisions. When recession threatens, it can move swiftly to supply banks with more reserves and to make credit more available and less costly; but it cannot compel banks to lend to customers, nor customers to borrow from banks. It can only make the process easier and cheaper.

In short, monetary policy is not a stabilization instrument that stands alone. It is only one member of a team, only one tool in a kit of tools, only one weapon in an arsenal for smoothing the path of the economy toward sustained expansion. But it does possess the special virtue of being subject to rapid change with modulated intensity. It can apply credit in small doses or in larger ones, sometimes called "active ease". Although the increased use of fiscal policy as a contracyclical tool would be desirable, past experience indicates that tax and expenditure changes are lumpier, less easy to adjust by small amounts.

Because fiscal policy has thus far been both a slower and a cruder instrument than monetary policy, it has seemed to some that too much has been expected of monetary policy at certain times. For example, during 1959 virtually the entire burden of restraint fell on monetary policy. In that year, total credit expanded by about \$60 billion, one third more than the previous peace-time record. Mortgage debt, consumer debt, and business borrowing all rose rapidly, as did borrowing by state and local governments. Superimposed on these heavy credit demands was record borrowing for peacetime by the Federal Government after the 1958 recession was over. Because

of the interest rate ceiling, the Treasury had to confine its borrowing largely to the short- and medium-term area and, therefore, had to follow a policy of adding to, rather than absorbing, liquidity in the economy. This rapid over-all expansion of credit placed a heavy burden indeed on monetary policy; credit control was compelled to function as the chief vehicle of restraint during this boom period.

While a major task of monetary policy has always been and will remain that of short-run stabilization of business activity and prices, so far as that can be accomplished through the regulation of bank credit and money, monetary policy actions also aim to promote the continued long-run growth of the economy. A growing national product requires a growing money supply; but the relation between these two magnitudes is not so simple that the money supply can be guided by an automatic pilot, as some have suggested. The needs for cash balances change and so the velocity of circulation varies. The structure of financial flows and liquidity requirements change also. Money supply must reflect all of these factors if it is to undergird our economic growth.

Growth comes from increasing our economic input of both human and material resources, and also from attaining better relationships between the input and the resulting output. This means higher productivity. A larger and more highly skilled labor force and greater investment per worker are among the means of expanding economic input. New and better production processes, better organization, and expanding markets make for higher productivity.

The sources of productivity increase are to be found chiefly in the decision-making process within business itself. There are limits to what government can do to encourage higher productivity, except to maintain competition and to avoid diluting incentives to innovation. Government can, however, help keep the economy on a reasonably even keel so that growth does not proceed fitfully but at a steady rate. The basic condition for growth is to keep private incentives alive: incentives to save, to innovate, to invest, to compete.