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CHANGES IN MONETARY AFFAIRS

Remarks of C. Canby Balderston,

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

Before the Fourth Annual Regional Conference of Student Chapters,
Society for the Advancement of Management,

Fordham University,

New York, New York.

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CHANGES IN MONETARY AFFAIRS

The meal you are about to be served has the following menu:

(1) Bank competition and bank regulation.

(2) Direct controls over materials, wages and prices and selective credit controls.

(3) General financial controls, both monetary and fiscal.

(4) Differences in the impact of monetary and fiscal policies.

(5) The adverse balance of payments.

Both here and in other parts of the world the pervasive role of banking has long been recognized. Banks have, therefore, attracted governmental regulation to an unusual degree. In our country, entry into the industry requires a federal or State charter. The establishment of branches must have official approval, except where State law prohibits branching entirely. The merging of our banks is controlled by law. Their soundness is checked by examiners. How much may be loaned to a single customer or upon real estate collateral is regulated. Although an effective monopoly in the holding of demand deposits has been given to commercial banks, they are not allowed to bid for such deposits by the payment of interest. Moreover, they are limited as to the interest they may pay on savings and time deposits, which hinders their competition for such deposits with rivals. The reserves they are required to keep are higher than those required of other financial institutions, and banks that belong to the Federal Reserve System must keep these reserves in non-earning form. Doubtless banks have needed the restraints placed upon them to prevent recurrence of the abuses of an earlier day; the bank failures of the 1930's were not the first outbreak of such economic sickness. Not only do banks handle other people's money, but the credit operations of the banking system as a whole influence economic activity.

But banks, bound around by so much regulation, have also faced new and vigorous competition in recent decades. These competing institutions serve to

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further mortgage and other long-term lending. Except for their time deposits,--usually not subject to unexpected withdrawals--banks have to eschew tying up an undue proportion of short-term funds in longer-term investments. And so there is a place for mutual savings banks and for savings and loan associations. The latter's share capital has grown 340 per cent during the past decade, while the savings deposits of commercial banks were growing only 115 per cent. Savings and loan associations bid actively for long-term savings to place in mortgages. Some also advertise for short-term funds that flow from all points of the compass to the highest bidder. The quick withdrawal of such "hot money" would teach once more the lesson that adequate liquidity should be maintained against any holdings of such volatile funds. There are other areas that banks at first disdained to enter. In one of these, consumer credit, finance companies and credit unions led the way and banks followed belatedly. Since 1951, the share capital of credit unions has grown over 400 per cent. Thus banks face sterner competition both in making loans and in securing deposits.

One cannot deny the necessity for legal and supervisory restraints upon banks to prevent the repetition of past evils. It is opportune, however, to ask how much regulation is optimal. Are banks likely to suffer from supervision to the point where their social functioning is impaired? How much regulation is too much? Excessive regulation may hold back progress by stifling initiative and the willingness to venture. It gives one pause that some commercial bankers prefer relatively riskless investments to the making of business loans needed by their communities.

In contrast, some--but not all--bankers have long wished to be permitted to pay higher rates of interest on savings and time deposits. They have wished to become more competitive at home and abroad to attract and retain savings. The recent lifting of the previous ceiling helps such banks to woo the saver, to reward

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him, and perhaps to stimulate the saving process. This permissive relaxation of a ceiling that had been unchanged for five years called forth sincere, pained protests. The previous restriction had been clutched by some bankers as a protective cloak against the competitive winds. It is to be noted, however, that half of the banks increased their rates on savings deposits shortly after the effective date of the relaxation. Over two-thirds raised their rates on time deposits other than savings. Some wished to court savers and depositors; others acted merely to meet competition.

This recent history is recited to point up the question as to how much bank regulation is just enough to prevent abuses that endanger bank solvency without being too burdensome on the banks themselves or upon those they should serve.

While the rivals of commercial banks have been growing in number and size, the credit furnished by all types of institutions has multiplied. In 1945 mortgage debt on all properties amounted to $35.5 billion, of which $5.4 billion was held by savings and loan associations. The current figures are over $220 billion and $68 billion, respectively. Another spectacular rise has been in consumer instalment credit. At the end of 1945, it amounted to less than $2.5 billion; now, to over $42.5 billion. Of these amounts, credit unions furnished only $100 million in 1945 as compared with nearly $4.5 billion at present. Whatever one's views as to the social desirability of so much consumer credit, of which about $17 billion is in automobile paper, or from such heavy mortgage debt, of which $150 billion is on houses ("one- to four-family"), such credit introduces us to that form of financial control labelled "selective".

During World War II, selective control over consumer credit was employed along with direct controls, such as rationing, and price and wage controls. Again, during the Korean war, along with the revival of direct controls, the regulation of consumer instalment loans was reimposed to restrict the purchase of consumer durables,

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like autos and radios. The administrative difficulties growing out of the imposition of such detailed regulation may be visualized from the fact that it covered 200,000 retail firms. The latter were not all imbued with the requisite patriotism for voluntary adherence to regulation, and although selective credit control did help to dam up consumer demand during the War, it did not prevent an eventual outburst of higher prices.

Close relatives of selective credit control are the direct controls already mentioned. Once World War II had ended, nations began to shake off such controls. One outcome was the progress achieved toward currency convertibility by Britain and the nations of Western Europe. By 1959, it was for all practical purposes an accomplished fact. For importers to be able to pay, in the currencies of their own countries, for goods they had bought was a boon to international trade.

The discarding of wartime controls in favor of general controls, both fiscal and monetary, marked a return to free enterprise, and to the decentralized decision making it permits. The freedom to make private economic decisions is a vital part of our system of economic and governmental organization. It is essential to freedom of the individual, which can be preserved only so long as it is accompanied by wisdom and restraint.

The role of monetary policy is to regulate the reserves available to commercial banks so as to promote economic growth, high levels of employment, and reasonable stability of prices. It is this responsibility, so vital to the protection of the integrity of the dollar, that has been delegated by Congress to the Federal Reserve. Yet the latter regulates money and bank credit only as to their total supply, not their allocation to firms and individuals. Such allocation is left to the competitive forces of the market, except where Congress intervenes through taxes, appropriations, or governmental guarantees, or where supervisory regulations govern bank liquidity and soundness. Thus, in the main,

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decentralized decision making of individual borrowers and lenders determines the use of the economy's resources.

The great value of monetary policy as a contra-cyclical device is its flexibility. This flexibility makes the timing of monetary actions more precise and manageable than is the case with fiscal policy.

Fiscal policy embraces debt management, federal spending, and taxing. Although in the long run it may be even more potent in helping promote economic growth and stability than is monetary policy, inability to time its impact makes difficult its effective implementation to combat cyclical variations. It may be said that our present fiscal structure possesses tremendous contra-cyclical automaticity, with substantial deficits developing even in mild recessions, and disappearing with recovery to nearly full utilization of resources. Yet any more delicate adjustment to combat cyclical movements through changes in governmental spending and taxing is difficult, because the impact is so delayed that the stimulation is likely to be felt after the private sector has already recovered. The result is to pyramid demands to the point where resources--human and other--are placed under strain, and costs and prices are pushed upward.

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, a reminder that spending decisions should take into account how the bill will be paid. This competition for savings with large and growing borrowing demands from private industry, and from 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

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time mark the high level to which interest rates were pushed. U. S. interest rates then were at 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.

Now I turn to recent shifts in emphasis in the management of the monetary and fiscal affairs of our country. Other industrialized nations, such as Great Britain, have long recognized the necessity of maintaining international equilibrium in their balance of payments. But in the United States the problem was different because this country held the major portion of the gold stock of the western world and also possessed the productive capacity to re-equip the devastated nations. And so, until 1958, the United States was concerned about a problem diametrically opposite to our present international worry. The two wars had so dissipated the productive capacities of industrialized nations and their financial stability as to create a "dollar gap". The war-torn countries, though they needed our exports of material and of American-made equipment to rebuild their economies, did not have the dollars with which to pay for them. The problem of the United States was to make our allies and former enemies into viable customers again. We sought to bridge the dollar gap through private investments in, and governmental loans and guarantees to, these countries. So well did we succeed that the Marshall Plan is recognized as a signal success.

By the late 1950's, the other industrialized countries had rebuilt their manufacturing plants and had improved their management techniques so greatly that they were not only in a position to supply more of their own rapidly-growing domestic demands, but to compete vigorously for the export markets of the world.

One effect of the emergence of new productive capacity here and abroad is downward pressure upon the prices of such physical goods as move in world trade.

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Our firms have begun to appreciate that excess, or even ample, productive capacity is a powerful brake upon price advances. No longer can they float off the effects of imprudent wage-setting in the form of higher prices, because new choices have been opened up to the consumer in the form of alternative sources and substitute products. Gradually the idea that an upward price drift is inevitable has been dissipated as wholesale prices have moved slightly downward. The disappearance, for the time at least, of the expectation of price inflation has permitted the Federal Reserve to continue to foster the expansion of bank credit in a way that would not have been prudent for our country if price advances had stimulated inventory building and other forms of speculative ebullience.

Although the removal of direct and selective controls by other countries, as they recovered from the damages of war, was a great advance for them and for world trade in general, it created fresh problems and challenges for the United States. Once the currencies of leading countries became convertible, funds could flow from one financial capital to another with alacrity. Their movement may be impelled by such forces as interest-rate differentials and speculation. And so this basic change has caused our fiscal and monetary policy-making to reflect the need to maintain world confidence in the integrity of the dollar. Serving as a reserve currency and therefore as an alternative to gold, the dollar plays such a vital role in lubricating international trade that loss of confidence in it would be damaging both to the western world as a whole and to the United States. An adverse balance of payments means to a foreign observer that our exporting is not large enough to pay for the investing, lending and spending that our government and its citizens do abroad, and that our industry is failing to attract the dollars that are available in the world.

The imperative need to improve our adverse balance of payments means that either the United States must have more help from the industrialized nations

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in carrying the military and economic burdens of the western world, or our margin of exports over imports must be increased. Our country has had an adverse balance in each year since 1950 except for the one year of 1957. During each of the last four years the red figure has been between $3 and $4 billion, excluding prepayment of debt. The consequent accumulation of foreign claims upon our liquid dollar assets has increased especially fast when interest differentials induced American and foreign holders of funds to invest them elsewhere, or when speculators preferred to hold gold or some foreign currency instead of dollars, or some foreigner delayed debt repayment to an American firm in the expectation that the dollar would become cheaper or that his own currency would be revalued upward. At times the outflow of gold was strong, as in 1958, when the figure reached $2.3 billion; at other times, as in 1959, the outflow was small even though foreign claims continued to mount. Fortunately, our exports have been exceeding our imports by a healthy margin, thanks to the boom in Europe and in Japan. But this sizable balance in our current accounts has not been sufficient to offset the outflow of private capital that has resulted from American investment abroad, and from the borrowing by foreigners from our American banks, plus our vast governmental expenditures and lending abroad.

Inducing other nations to assume a significant portion of the military expenses of the western world, and of the capital needs of underdeveloped countries, is a task for our Defense and State Departments. It is beyond the compass of my discussion, and so I shall return to the other side of the equation--the increasing of our trade balance so that we can improve our ability to pay for our foreign investing, spending, and lending. The essential point is that our exports must exceed our imports sufficiently to pay for our new investments abroad, plus the military expenditures and economic aid across the seas that our world leadership seems to entail. This means products of the right design and quality offered at

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the right terms and prices. It is important to encourage American inventiveness to create new products for the markets overseas. Our country is rich in resources and in management know-how. But how much it can invest, spend, and lend abroad depends basically upon how much more it exports than it imports.

This means that our firms must be competitive in world markets. Foreign customers will not remain wedded for long to American suppliers because of past favors, if they fail to offer a better product at a lesser price. It is time, therefore, to take stock of our wage-setting and pricing policies to the end that the prices quoted may promote the export trade needed to finance our country's obligations. If we inflate more than other countries, American firms stand to lose an increasing share of the world market. The problem is similar with respect to imports entering our own markets. To export freely we must import freely for the raising of tariff and other barriers would not only invite retaliation, but conceal the basic problem of keeping competitive. Since America's goals will not be achieved by inefficiency, the essential task is to keep down our costs by investing, managing and working effectively.

Dr. Arthur F. Burns gave a prescription as to how to meet our economic challenge in his talk last May to the American Iron and Steel Institute:

> "- - - unless the government moves prudently in increasing the money supply and its own rate of spending; unless trade union officials keep their demands for wage increases from exceeding improvements in general productivity; unless the government refrains from passing laws that raise wages or prices; unless business firms and trade unions join in efforts to remove restrictive labor practices and the featherbedding in which both executives and workers sometimes indulge; unless the government reforms our tax system in the interest of stimulating greater effort, more productive investment

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"and higher efficiency; unless business men innovate vigorously and lower prices whenever possible; unless these things are done and a liberal policy toward imports is continued, we will not avoid new and successive rounds of inflation."

A more immediate threat, however, is the risk that if these steps are not taken, funds will flow abroad that otherwise would seek investment at home and thereby help to create jobs. This outcome would not be remedied, but worsened, by an overly liberal fiscal policy and by too easy money. On the contrary, the task that faces our country involves hard thinking and hard decisions both for government and for business and labor.

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