For Release on Delivery

(Approximately 6:00 p.m.
Central Daylight Time,
Thursday, September 20, 1962)

TWIN GOALS OF MONETARY POLICY

Remarks of C. Canby Balderston,

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

Before the Twenty-Third Annual Conference
of the Public Expenditure Survey of Wisconsin,

Milwaukee, Wisconsin.

..AN GOALS OF MONETARY POLICY

The Nation's economic goals are to maximize employment opportunities and living standards at home without sacrifice of the dollar's exchange value abroad. In human terms, our breadwinners of all ages and young folks who have finished school need job opportunities; our family shoppers, widows and retired folks need stable prices. But these domestic objectives must be harmonized with the international position of the dollar. Otherwise our ability to compete in the markets of the world and to sustain our position of world leadership will be injured. These national goals are also the broad goals of the Federal Reserve System.

Much of the responsibility for achieving the national economic objectives rests with Congress. Although it has ultimate responsibility to maintain the quality of our money, Congress has delegated the direct responsibility to the Federal Reserve. The fact that money, as a medium of exchange and a standard of value, pervades all parts of the economy means that the quality of the service it renders links the goals of Federal Reserve policy to those of the Nation as a whole.

In particular the System keeps watch over the integrity of the monetary unit to the end that it will be the servant of the people and not their master. It does this by regulating the volume of legal reserves made available to the commercial banks, thus influencing the cost and availability of bank credit and the amount of bank-deposit money in the hands of the public. Thus monetary policy takes into account not only the level and trend of economic activity, but also related questions, such as the degree of inflationary or deflationary pressure, the presence or absence of speculative ebullience, and the international economic environment.

The influence of the Federal Reserve is at all times marginal, though this margin may be decisive. The credit extended by commercial banks through which the Fed operates, accounts for only a small proportion of the Nation's total credit volume. In 1959, for example, the total expansion in credit amounted to $61 billion, but the banking system provided only $5.6 billion of this amount. This was a year when monetary policy needed to be restrictive. In 1961, when monetary policy was easier, the banking system provided $17.5 billion of a total $53 billion credit expansion. These figures serve not only to indicate the rough proportions of bank to total credit, but also the changes that may occur in this proportion in response to changes in monetary policy.

To recapitulate, the Nation has twin economic goals: domestic ones and international ones, but these are interrelated. The Fed's job is to influence bank credit, which is four-fifths of the money supply. It does not control the allocation of the money supply to particular industries, governmental units and individuals. That allocation is left to competitive bargaining between lenders and borrowers and thus reflects the market forces of supply and demand.

So much for the goals. What of the performance? Without belittling the magnificent physical basis for a good life that our economy provides for a majority of our families, what with an auto for every 3 persons and abundant telephones and televisions, the Nation's recent economic performance has been sufficiently unsatisfactory as to prevent complacency.

Domestically, the economic growth rate has slackened; recoveries from each of the last two recessions were less vigorous than from past ones. As a result, unemployment has remained distressingly high--over 5 per cent of the labor force--productive facilities have not been utilized fully, real output has been lost forever, and the investment in new and better facilities so important to future economic growth has been disappointing. We are in the difficult years between the restocking boom following the war and the maturing of the bumper post-war baby crop.

Abroad, we are faced with increasingly vigorous competition from industrial plants rebuilt after widespread, war-time destruction. In many lines, the new modern industrial facilities of such nations as Germany, France, Italy and Japan are hard to beat. Meanwhile, the cold war continues to call for heavy expenditures to protect our national interests. Although our country exports substantially more goods and services than it imports, this favorable balance of trade, though large, has fallen short of what is needed to pay for our private investments, military expenditures and Government loans and grants abroad. The result has been a persistent deficit of $2-1/2 to over $3-1/2 billion annually in our international balance of payments.

The failure to earn enough foreign exchange to cover our foreign investing, lending and spending has piled up short-term dollar claims in the hands of foreigners. These claims tend to come to rest in the central banks of other industrialized countries as their nationals convert the dollars they have obtained into their own currencies. And when a given central bank has all the dollars it wishes to hold, it uses the rest to buy gold from us. The resulting exodus has been at a rate fast enough to cause us to seek measures, without resorting to restrictions upon the flow of trade and capital, that will stop this pyramiding of liquid dollar claims against us.

This is not to say that as a nation we have fallen completely short of our economic objectives. Our GNP stands at an all-time high even though the rate of economic growth has been less rapid than our productive and technological resources would permit. Integrity of the dollar has been maintained with commodity prices constant for about four years, and progress is being made in redressing our balance of payments.

These are fundamental explanations for the economic situation in which we find ourselves. The range of needed remedies seems wide and varied, and involves a combination of wise and forward-looking public and private planning. But one central requirement for the solution of our economic problems--both domestic and international--is the restoration of greater vigor in the conduct of our economic affairs. And one important stimulant, in my opinion, would be better profit potentials. It is not enough to save; entrepreneurs must be willing to venture as a result of their profit expectations.

Have such incentives really suffered in the post-war years? This is a difficult question, but I think that the affirmative can be argued. Higher taxes, rising wage and operating costs, and the loss of buoyancy in many markets certainly have made it more difficult to carry a satisfactory margin down to profit. Despite the many billions spent on new and improved facilities and equipment, profits after taxes per dollar of sales of manufacturing companies have dwindled from 5.8 per cent in 1948 to 4.8 per cent in 1957 and 4.3 per cent in 1961--all years of mixed prosperity and recession. This calculation excludes funds retained through depreciation charges, which have been rising in relation to sales but which are needed in the long-run to maintain our productive facilities.

What has happened is that in the post-war years, we have built a high cost structure into our economy. Wages and salaries, fringe benefits, taxes, overhead--all have risen regularly from year to year, and in most cases have exceeded the substantial gains in productivity that have been achieved. In the earlier post-war years, when markets were strong and competition moderate, these higher costs could be passed on through higher prices. But as the most urgent market demands have been satisfied, and as competition has become more severe at home and abroad, more and more cost advances have had to be absorbed.

Cost-price controversy often centers upon the upward trend in wage and related costs. But certain other costs have risen even more rapidly than payrolls. Thus, according to a First National City Bank study, the proportion of the sales dollar that the 100 largest manufacturing corporations paid out for materials, payrolls and fringe benefits fell slightly between 1949 and 1961, from 82 to 80 per cent. Surprisingly, the proportion of sales taken by Federal income taxes also dropped a bit, from 4.2 to 3.8 per cent. But other tax payments, including State and local, rose from 2.2 to 4.6 per cent while depreciation charges rose from 3.6 to 4.7 per cent of sales over the 12 year period. It was these cost elements that cut after-tax earnings of the 100 firms from 7.6 to 6.0 per cent of sales between the roughly comparable years of 1949 and 1961.

The rise in State and local taxes is reflected in the accompanying charts that my colleagues at the Federal Reserve Board, J. Charles Partee and Richard C. Pickering, have prepared. Their analysis shows that State-local activities, however measured, have grown more rapidly than the economy and faster even than Federal programs. On the first page of charts, the first panel illustrates the steady growth in State-local purchases of goods and services, both in absolute amount and in relation to the GNP. The second panel indicates the similar movement in tax and other receipts in comparison with the national income. Employment in State-local activities has mounted with especial speed, as the third panel shows, so that in recent years the number of State-local jobs has exceeded total Federal employment, including the armed forces. Indebtedness of the State and local governments also has increased steadily, by $4-$5 billion annually in recent years, reflecting mainly the heavy construction programs undertaken. As a result, the fourth panel shows that State-local debt has risen faster over the post-war period than has total public and private debt, while Federal indebtedness in relation to the total has declined markedly.

This expansion in State-local activity has been in response to very real and urgent needs--the requirements of a rapidly growing population, a rising standard of living, the post-war housing boom and the manifold demands for government services that have followed. Who would argue that there is no need for the schools, roads, public buildings and other facilities represented by these outlays? It is true that operating costs and salaries have risen, and debt servicing costs have ballooned, as shown by the charts on page 2. These developments, however, reflect the rising standards of performance demanded, the heavy needs for borrowed funds, and the inflation suffered by the economy as a whole.

The point I wish to make is simply that increased services entail increased costs, and that these costs must be borne by the public either currently in the form of higher taxes, or over the longer-term, in the form of a debt-servicing burden. We are a wealthy economy, and can afford the services that are really needed and useful, but we should be very sure to get our money's worth. Taxation, like direct wage and other production costs, adds to the already high cost-structure of our productive machine. And in our present environment where increasing competition prevents upward price adjustments, even marginal increases in costs, from whatever source, tend to squeeze profit margins and injure investment incentives. In our public affairs, as in private industry, unnecessary frills and expenditures add to an already inflated structure of costs and prices. These must be held in check, and opportunities for the profitable employment of men, money and machines enhanced if we are to be successful in the competitive struggle for world markets.

The Vicious Spiral and the Job Killers

So far I have made the point that the goals of monetary policy are interrelated and that the domestic ones cannot be separated from the international. Even a small community will not prosper if its people just take in each other's washing: it must have cash crops. Fast moving trade is therefore a prerequisite to maximum employment. What destroys trade among ourselves and with others kills jobs. There is no mystery to unemployment that realistic thinking will not uncover.

Of what does the vicious spiral consist? At the risk of oversimplification, I shall list some considerations from which it springs.

(1) Goods will not sell well at home or abroad unless they are attractively designed and priced.

(2) They will not be priced attractively if the costs of producing and selling them are inflated by waste and inefficiency.

(3) One source of waste is the misapplication of resources--human and other--that happens when bad investments are made in the private sector or useless expenditures in the public one. The productive efficiency necessary to keep costs competitive requires continued investment in improved plant and equipment, but such investment calls for the willingness to venture funds as well as their availability. The willingness to venture is weak if profit expectations in general have been diminished by a cost squeeze. A cost squeeze and a drop in profit expectations is the classic way in which competition eliminates weak firms and forces contraction in industries where product demand is on the decline. But when all business suffers a cost squeeze, there is no place for savings to go, except perhaps to finance a Government-deficit or into foreign investment.

(4) Taxes are rising more rapidly than the national income, particularly at the State and local levels. This is one facet of our inflating cost structure. Taxes *per se* are not to be condemned but only that part of taxes that results from unneeded projects, featherbedding and other wasteful expenditures. For instance, better schools make for a labor force that is more viable, just as necessary roads help move materials and people to the places where needed. But featherbedding, whether in the public or private sector, makes jobs for some people only by destroying job opportunities for others. If American products are priced out of world markets, or if consumption at home is diminished by adverse consumer reaction, job opportunities are killed and people go unemployed. Trade is indeed a magic circle that has within it the means of attaining our economic goals, including maximum employment. But uncontrolled costs, whether governmental or private, are job killers.

The foregoing discussion of our economic goals--domestic and international--suggests that neither class can be isolated and dealt with separately from the other. In the framing of monetary policy, it is the optimum combination of the two sets of goals that should guide. Success in their attainment will depend upon appraising our strengths and weaknesses with realism and courage, and then making those hard decisions that are needed for the long-run health of the economy.

Charts to Accompany Remarks

on

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by

C. Canby Balderston

Vice Chairman, Board of Governors of the Federal Reserve System

at the Twenty-Third Annual Conference

of the

Public Expenditure Survey of Wisconsin

Milwaukee, Wisconsin

September 20, 1962

Chart 1

GOVERNMENT PURCHASES OF GOODS AND SERVICES

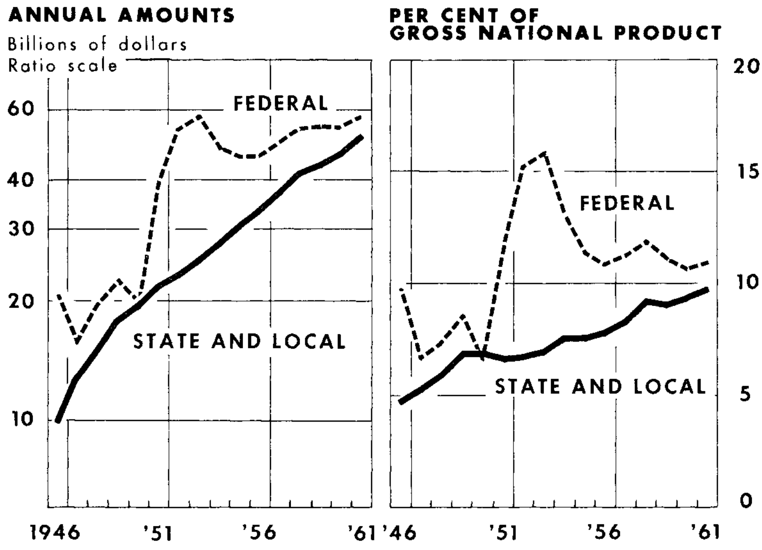


Chart 3

GOVERNMENT EMPLOYMENT

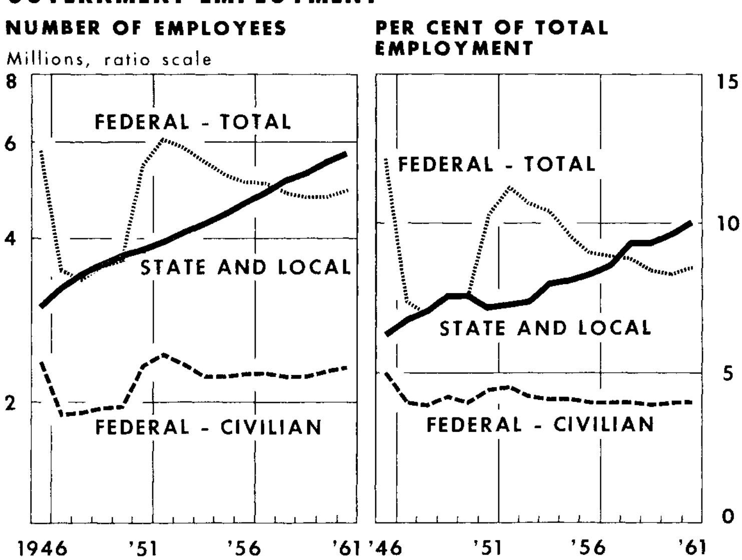


Chart 2
GOVERNMENT RECEIPTS

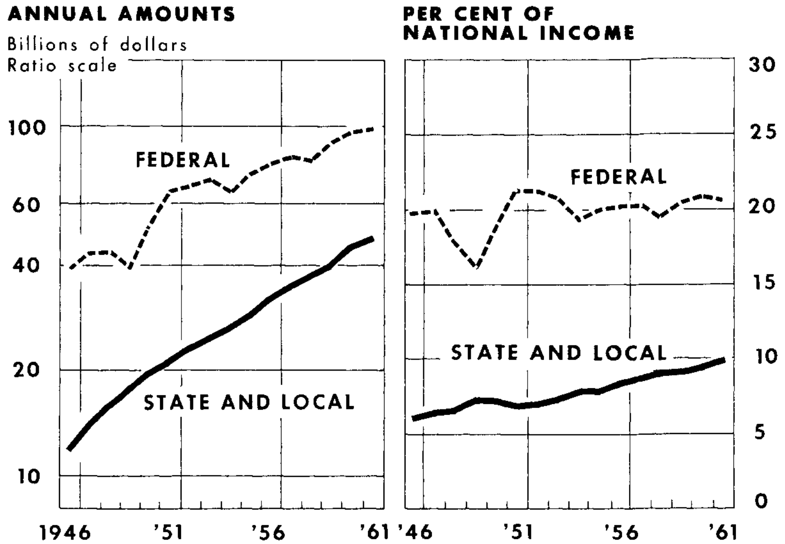


Chart 4
GOVERNMENT DEBT

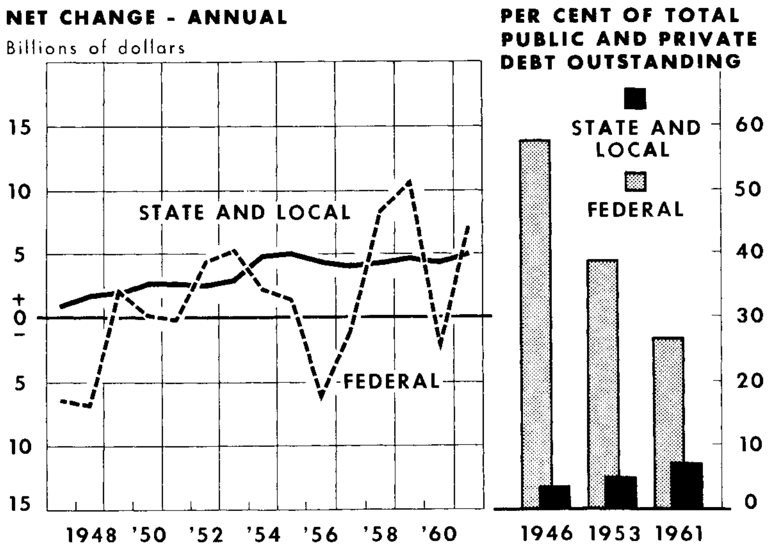
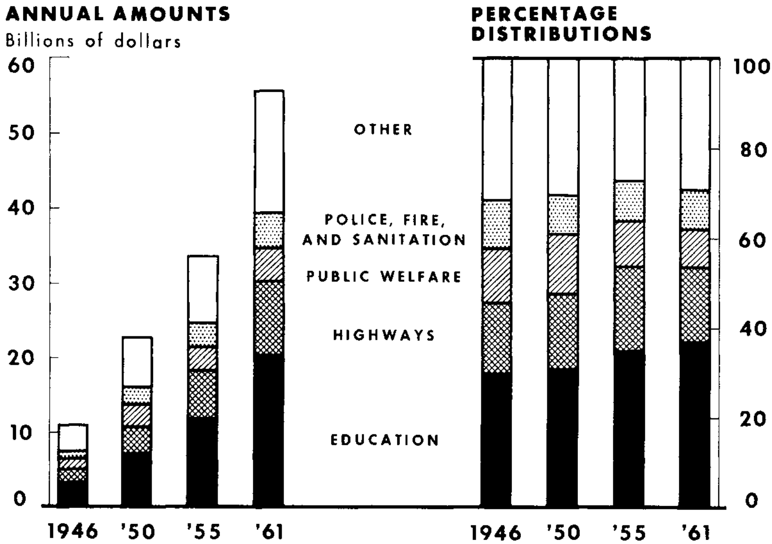


Chart 5

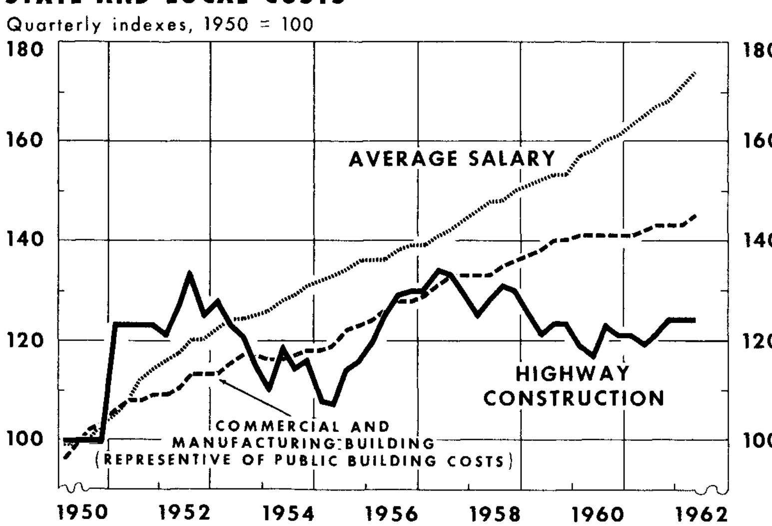
STATE AND LOCAL EXPENDITURE, BY FUNCTION



BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Chart 7

STATE AND LOCAL COSTS



BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Chart 6

STATE AND LOCAL EXPENDITURES FOR DEBT SERVICE

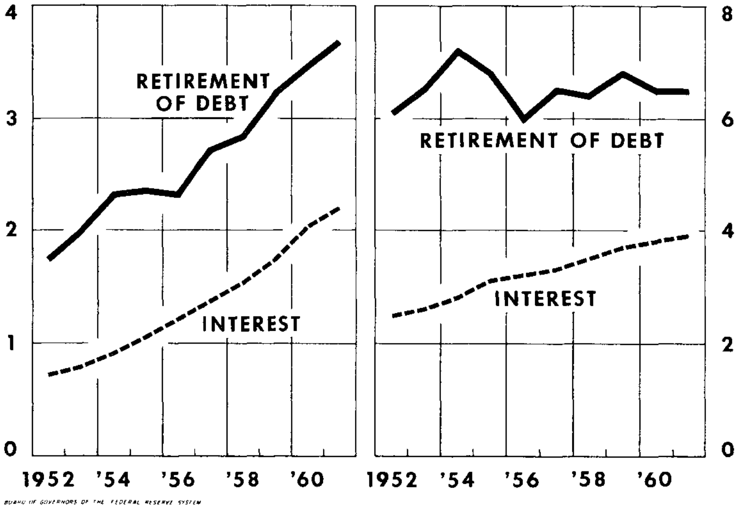
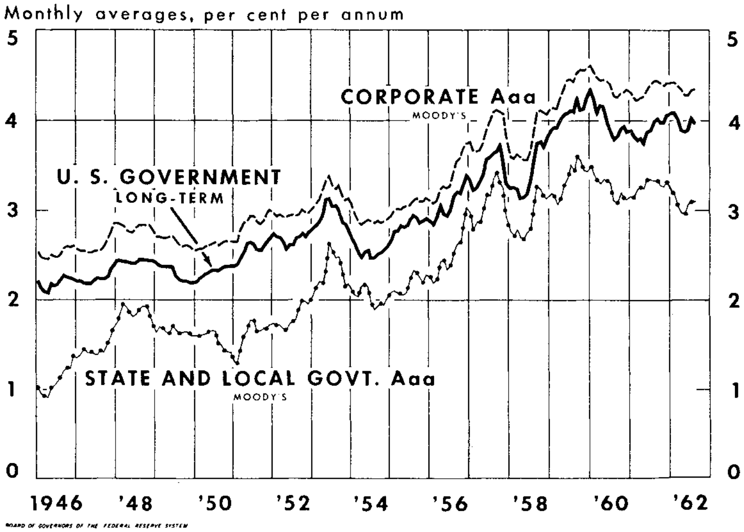


Chart 8

BOND YIELDS



NOTES TO CHARTS

Government Purchases of Goods and Services

Calendar year data from U. S. Department of Commerce. Government purchases consist of compensation of employees, new construction expenditures and other purchases from business for general governmental purposes included in the Gross National Product accounts. Excluded are purchases of government enterprises.

Government Receipts

Calendar year data from U. S. Department of Commerce. Government receipts consist of tax revenues, charges and fees for government products and services (except those accounted for under government enterprises) and contributions for social insurance. Federal grants to State and local governments are excluded from State and local receipts to avoid duplication. Government receipts are shown as a per cent of National Income, as customarily defined, plus indirect business tax and nontax accruals.

Government Employment

Calendar year data from U. S. Department of Commerce. Number of employees, both total and government, is in terms of full-time equivalent employment, which measures man-years of full-time employment of wage and salary earners and its equivalent in work performed by part-time workers. Total Federal employment includes military as well as civilian employees; both Federal and State and local data include employees of Government enterprises as well as general Government employees.

Government Debt

Data are from U. S. Department of Commerce and represent changes during, or debt outstanding at the end of, calendar years except for State and local governments which are for fiscal years ending June 30. Total debt includes long- and short-term corporate, noncorporate business and individual indebtedness as well as government debt; both total and government debt is net of certain types of duplicating debt.

State and Local Expenditures, by Function

Data are for fiscal years from U. S. Bureau of the Census. Expenditures include general government expenditures for current operation, capital outlay, assistance and subsidies, and interest; they exclude utility, liquor store and insurance-trust expenditures and debt redemption. "Other" includes expenditures for health, hospitals, natural resources, housing and community development, local recreation, general control, interest on general debt and miscellaneous unallocable expenditures.

State and Local Expenditures for Debt Service

Data are for fiscal years from U. S. Bureau of the Census. Expenditures for interest and retirement of debt include those for utility debt as well as for general government debt. Revenues from own sources include utility revenue as well as that from general government taxes, charges and fees, but exclude revenue from Federal grants and proceeds from new debt issued. Retirement of debt includes long-term debt only.

State and Local Costs

Data are quarterly indexes; 1950 average equals 100. Average salary is based on Department of Commerce monthly estimates of State and local government payrolls and Bureau of Labor Statistics estimates of employment. Commercial and manufacturing building costs are compiled monthly by E. H. Boeckh Associates, are averages of indexes for 20 major pricing areas, and are used to represent probable costs of constructing public buildings. Highway construction costs are based on quarterly indexes compiled by the Bureau of Public Roads on the basis of average unit prices for common excavation, portland cement concrete pavement, bituminous concrete pavement, reinforcing steel, structural steel and structural concrete with quantity weights.

Bond Yields

Data are monthly averages. For State and local bonds, yields are averages of Thursday figures for five general obligations bonds of the highest quality with average maturity of about 20 years. For corporate bonds, yields are average of daily figures for about 30 industrial, railroad and utility bonds of the highest quality with average maturity of 23-26 years. U. S. Government bonds yields are averages of daily figures for all fully-taxable bonds maturing or first callable in 10 years or more. Corporate and State and local yields are compiled by Moody's Investors Service.