THE SEARCH FOR ENDURING PRINCIPLES

Remarks of G. H. King, Jr.

Member of the Board of Governors

of the

Federal Reserve System

at Commerce Day

University of Mississippi

Oxford, Mississippi

May 12, 1961

THE SEARCH FOR ENDURING PRINCIPLES

The purpose of Commerce Day, as I understand it, is to provide an added channel of communication between students of business and some of its practitioners. It gives students an opportunity to hear of the problems and responsibilities assumed by those of us who are actively engaged in business and government. Perhaps it should also be viewed as an opportunity for those of us in the world of affairs to learn more about your views and problems. I was a student 20 years ago, and I remember that in those days it was difficult for me to become very interested in serious talk. I am sure you realize that I have no choice but to talk seriously today. This being so, I hope you find some interest in what I say.

If this interchange of views is to be constructive, we should concentrate only on critical problems and not on those of only passing relevance. What factors will be critical to you at the important turning points in your business careers? These factors will be the "enduring principles" of our economy and not the ever changing pattern of techniques. Most of you who are students will approach the peak periods in your careers anywhere from one to three decades from now. The world will undoubtedly be greatly changed. The frequent translation of what was yesterday's science fiction into the reality of today warns us of the rapidity of change. Some of the things you are learning now will have become obsolete by that time. New skills will have to be acquired after you leave school. But some basic principles will endure. My general purpose will be to tell you how I try to distinguish temporary elements from enduring principles.

I could discuss this problem in a philosophical way; but, instead, let me illustrate my approach to it by a description of some of the problems I face in the work in which I am engaged.

The Board of Governors of the Federal Reserve System, of which I am a member, is the central bank of the nation. It has a variety of responsibilities, the leading one of which is the management of our monetary system. The end objectives of this management are economic stability and growth at a sustainable rate. One of the principal ways in which these objectives are serviced is through preserving the value of our monetary unit. While this seems like a simple task aimed at simple objectives, the process is a complex one. Furthermore, it illustrates the question with which I started this talk: What are enduring economic principles and what are changing factors? As I hope to illustrate, this is a knotty problem, and ready-made answers are hard to find.

The Federal Reserve is banker both for the Federal Government and for the banking system. Although the Federal Reserve's function as banker for the Federal Government is relatively important, I shall say little on that subject. This function includes the many problems faced by the Treasury Department in servicing our Federal fiscal system and as manager of our large public debt. I shall, however, deal mostly with the Federal Reserve as a banker's bank. Operating bankers themselves need a banker; one that is a source of credit, an operating depository, a source from which they can restore their supplies of currency, and a channel through which they can collect their checks. The Federal Reserve System fulfills all of these functions.

This list, however, does not include the most important and critical of all Federal Reserve responsibilities; that responsibility is the management of our monetary system. Banks, as holders of deposit funds, are the leading creators of money. While individual banks, much as the rest of us, often feel that they have too few funds at their disposal and could use considerably more, the banking system is intended to operate in a way that will supply the amount of credit and money needed by the economy; no more and no less. Balancing of restraint and ease in the credit markets must be guided by the economic needs of the nation as a whole. Put in blunt terms, the expansion of bank credit and money should be checked somewhat when business booms get too exuberant. We know that wild booms produce subsequent economic relapses which, in turn, produce many forms of economic misery. Credit and money, however, can be made more freely available when the economy is not in danger of inflationary boom.

This managerial problem would be simple if such round phrases as "the economic needs of the nation" could be readily and precisely determined. In fact, however, these needs are never easily discernible. We must weigh what different individuals think they need and try to balance these various needs in a way that will serve the general public interest. At times, very real conflicts develop between various kinds of needs. Recent developments furnish an important example of these difficulties.

As most of you know, our economy suffered a recession throughout the second half of 1960 and into the first quarter of 1961. Between July 1960 and February 1961 the production at factories and mines declined by about 7 per cent; less than in some other recessions but unmistakably a serious and significant amount. Even more sobering was the influence of this downturn on the employment of plant capacity and manpower. The number of persons unemployed rose well above 5 million and has been at a level uncomfortably close to 7 per cent of the total labor force. We should note, moreover, that successive recoveries since World War II have witnessed successively higher unemployment percentages even during the upswings. Some have referred to this as "structural unemployment."

Since this phrase seems to mean various things to various persons, perhaps I should give you my idea on the subject. No one can state with absolute certainty what causes this phenomenon. It seems reasonable to me, however, that one of the major causes, if not the main cause, is the fact that wages and salaries have been raised substantially more than commensurate increases in productivity. Perhaps I am overlooking some cogent reasoning, but it seems a relatively simple thing to me that when the price of anything is held up artificially in a market economy, this only provides increased opportunity for competing items to capture that market. In the case of labor, the competing item is machinery. If the cost of people's efforts is to be pushed higher and higher in the vain hope that this will promote prosperity, then we are likely to witness an astounding amount of automation introduced at a rate faster than the displaced workers can be reabsorbed into other lines of activity. Automation and increased productivity are excellent things but we are all losers when we fail to use our manpower resources fully. However, higher utilization of labor is not likely to come until we abandon hopeless attempts to better man by requiring that he be paid more than his work is worth in what is otherwise a free market economy.

Some would challenge what I say as being inhumanitarian, but I believe it is far more humanitarian to support measures that keep people at work, especially at a time when unemployment is high. Our problem is really this simple -- and its solution could be equally simple; but we Americans have a penchant for trying to make simple things complicated.

After having digressed into my own philosophy of this persisting problem, I will return to the current problems of the recession which we believe is tapering off. As is generally true in periods of recession, consumer purchases of automobiles and other durable goods have been curtailed. Unlike earlier recessions, the housing market did not respond to greater availability of mortgage funds but continues to be relatively weak. On the other hand, business plans for capital spending, while slightly curbed, have been sustained at quite high levels. This reflects optimism even though there is a growing margin between the capacity of industry and its utilization.

The normal Federal Reserve action under these circumstances would have been to ease credit, mainly by purchases of government securities in open market operations and by reductions of Federal Reserve bank discount rates. Credit has been eased in fact, but not by all of the usual means. The need for new methods of creating ease is because of a development of considerable interest to all of us: the changed position of the United States in the world economy.

In recent years we have been sending more funds abroad than we take in from the rest of the world. This is partly the result of our assistance to foreign nations in the development of their economies. We have helped them become productive and prosperous because we know that weak allies are almost as bad as none. But now that our allies are strong, our own position in world trade is being challenged by these same allies. Speculators are also challenging our position as reserve banker to the free world. Added to these longer-run factors have been some shorter-term ones that caused us to lose some gold. This threat to our power and prestige has abated at the present time. We all hope that it has gone away forever. But, do we dare assume this and resume business as usual? I hope not. The stakes are too high for such lighthearted irresponsibility.

The effort we have made to restore economic vitality to the war-torn nations of Western Europe <u>may</u> have left us psychologically ill-prepared to face the fact that our own international position has become somewhat strained. In retrospect, it is quite clear that this change had been developing over a considerable period; it was not something that had emerged suddenly and without warning. Except for a brief and abnormal period around the time of the Suez crisis, the United States had been running a deficit in its balance of payments during most of the preceding decade. However, it was only in the recession of 1960 that the smart-money fringe of international finance started to take serious note of the fact that this deficit was denting our international monetary reserves.

The deficit in our balance of international payments takes two forms: the dollars credited to foreigners and the gold they withdraw. In the summer and fall of 1960 an abnormal fraction of foreign-held dollars was converted into gold. While our position was not greatly changed in fundamental terms from what it had been for several months beforehand, the gold flow was a clear message from the world of financial opinion that we must exercise financial prudence if we were to maintain our position of reserve banker to the free world.

The relationship of this international problem to domestic monetary policy lies in the factors that influence the movements of short-term funds into and out of the United States. To a considerable extent, the liquid funds generated in the process of the international exchange of goods are managed by foreign central banks and monetary authorities. However, with the lifting of exchange restrictions and the current convertibility of leading currencies, a sizable volume of such funds is in private hands. These funds could conceivably be attracted to those markets in which they can earn the highest rate of return. And it might be expected that the relationships of short-term money rates in the leading international financial centers would affect the directions in which such volatile funds flow. If short-term interest rates in the United States present too great a disparity from those in other money markets, we would likely lose such interest-conscious funds to money markets offering higher rates of return.

At this point we faced a conflict of considerations. The domestic needs for credit ease and lower interest rates conflicted with our international problem in which low interest rates _might_ have exaggerated further the outflow of short-term funds. In other words, the Federal Reserve was faced with the problem of meeting its domestic responsibility to provide monetary ease without aggravating the movement of short-term funds away from the United States.

We undertook to solve this problem by making reserves available to banks by means which would not drive down short-term interest rates excessively. For example, purchase of short-term securities aggressively in the open market would have tended to reduce their yield. Instead, the Federal Reserve made credit more available by allowing banks to count vault cash as part of their reserves. The authority for doing this was granted by legislation passed in 1959. The Federal Reserve also changed its techniques of operation in the open market. When the structure of interest rates could be safely left to the market, the System had dealt only in extremely short-term obligations. This operating rule had advantages both in practice and in principle under the conditions in which it was applied. But conditions change. Now, under differing circumstances, the maturities of securities purchased by the System has been extended. The purpose is to avoid concentrating the System's market influence on the short-term end of the market and to spread it to all sectors of the market.

Now, do these recent monetary experiences have any lessons for the students and practitioners of commerce? I think they do. The first conclusion is a rather obvious one: Our national pre-eminence cannot endure unless we take the necessary steps to sustain our basic competitive position. The confidence with which many of us viewed the position of the dollar in the early postwar period is somewhat like the complacency with which some old and established businesses have viewed their competitive position. In a world in which change is encouraged, complacency is a luxury we cannot afford. As a nation we have allowed ourselves to become so complacent that we doubt the sanity of anyone else who isn't complacent. Courage to face our problems squarely and take actions that will really solve them is a requisite to maintaining a free competitive system.

Another lesson flowing from this experience is that conflicts between objectives may require us to use essentially novel and even experimental devices in trying to accomplish a major goal without damage or harm to another objective. Principles endure; it is techniques that can be changed. This is a point of particular importance to the students of commerce. Techniques are only a means to an end. New circumstances may require new techniques.

A final important lesson to be learned from this experience is the enormous power of belief. What other nations believe to be the position of the dollar is almost as important as the technical facts about our balance of payments. Human beings require not just substance to nourish them, but faith and conviction. The beliefs that people hold of ourselves and of our nation are profoundly important, almost as important as the objective facts about us. Habits and customs may change, as they inevitably do, but the creature that lies behind these habits and customs -- man -- remains the enduring centerpiece of our concern. Commerce serves no function unless it serves <u>human</u> functions. Those of you who go into commerce will frequently be requested to endorse or oppose certain governmental actions.

Your decision in many cases will hinge on the degree of your faith in the free market system. The choice will be yours, and your collective decisions will play a part in shaping our nation's future.

And so I believe we students of economics would be well advised to speed an understanding with the student of the humanities. Such an understanding requires no capitulation from either if both really believe free markets provide an atmosphere conducive to man's maximum development of his capabilities. I believe that they do, and would submit that this is an "enduring principle" -- the principle on which the greatness of America has been built, and a principle which can provide a bright tomorrow.

In closing, I would like to quote a distinguished historian of our day, Bruce Catton, editor of American Heritage, who said, "Man's problem is not that he was born in the middle of the twentieth century, but rather that he was born in the middle of the human race."