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Statement of

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I am pleased to have the privilege of appearing before the Joint Economic Committee. The Employment Act of 1946 and the knowledge developed in the reports and hearings of this Committee have made major contributions toward the rapid, orderly, non-inflationary, growth of the United States economy and toward better public understanding of the problems involved in maintaining such progress.

I also welcome this opportunity because I believe the independence of the Federal Reserve System to be a keystone in our economy's proper functioning. Maintenance of independence is possible only with full public support. Hearings such as this give the Federal Reserve System an opportunity to explain the complexities of monetary policy. They enable the System to report on its stewardship while helping the people of the United States to shape their views as to a proper monetary policy.

I am sorry that as a result of these hearings internal conflicts will receive wide publicity. However, the action of the Board raising the discount rate was significant and worthy of a report to the country. I trust that the net results will be positive. I hope we will gain a better understanding of past action plus improved policies for the future.

Agreements and Disagreements

I was somewhat unhappy about the action taken by my fellow Board members on December 6. However, I want to make it clear that my dissent was not based on some of the reasons carried in the press. I do not fear that at this time higher interest rates will lead to an immediate depression or deflation. I respect the motives of all my fellow Board members. Each voted according to his own view of how a better economy could be achieved. The action was deliberative. Its timing did not arise from political or other ulterior motives. An attempt to characterize the votes as based on a belief in "hard money" or "easy money" is not helpful either. Each member clearly based his vote on how he believed the Board could best insure sound money and sound growth for the economy.

I disagreed on positive grounds. I felt that a discount increase at this time was premature. Furthermore, this action posed a net threat to long-run price stability. More specifically I concluded that:

(1) No sound decision was possible without firm information on the Federal budget. A delay of one month to await such knowledge could do little harm. It would enable us to make a much sounder choice.

(2) To act without far more effort at obtaining agreement on a coordinated monetary, fiscal and wage-price policy was wrong. The method and timing of the discount rate increase decreased its hoped-for impact. It threatened to introduce undesired, inflationary side-effects. It made the future development of sound full-employment

policies more difficult. Unilateral action could only weaken the President's leadership in a critical war period.

(3) Two major reasons cited by the majority for immediate action are, I believe, based on faulty theoretical reasoning. Their continued use as a basis for policy can only do harm.

(4) In departing from its normal and publicized policy of not making discount moves in advance of the market, the Board invested its recent decision to curtail credit expansion and raise interest rates with an urgency that I feel was unwarranted.

If I may, Mr. Chairman, I would like to expand on each of these four points.

A Month's Delay Seemed Advantageous

It can be no secret that, like people throughout the country, every Board member has diligently watched each critical economic variable. Growth this year has been excellent. Unemployment has decreased toward our interim goal. Our balance of payments has moved toward equilibrium, but not as rapidly as some hoped. Price pressures have exceeded those in recent years. Credit expansion was high.

The strains of growth have been severe. Continued progress toward full employment is bound to bring further pressures. Still, in prices, wages, and credit, distortions have been less than would be expected for a period of such rapid expansion. For example in non-food commodities (those most likely to be influenced by monetary policy) we note that although the rate of increase since midyear is slightly over one per cent a year, wholesale prices are only one per cent higher than six years ago. Non-food commodity prices in the Consumer Price Index rose about 3 per cent in the six-year period. Their increase in the past year was seven-tenths of a per cent. The United States price stability record in this period far surpasses that of almost every nation in the world.

The credit picture has been mixed. The major credit indexes show a high general rate of expansion in the first part of the year. From June through November, however, commercial bank reserves held in the System decreased. An economy expanding at a rate of over 7 per cent annually received no additional reserves.

Because existing reserves shifted to support time deposits attracted from other saving sources, total commercial bank credit continued to expand. The rate, however, was slower than in the first half of the year or in the two previous years. Other individual measures of credit showed differing reactions to the lowered reserves. Almost all grew more slowly than in the first half and most at rates below previous years.

As a result of this moderate credit restraint, interest rates rose sharply. On December 3, rates on short-term Governments were about a half a per cent higher than earlier in the year. Corporate and municipal bonds had risen about as much, while long-term Governments were up over a third of a per cent. All rates were close to their thirty-year highs.

On the whole, one could conclude on December 3 that the price and credit pictures showed signs of pressure arising partly from higher demand and partly from a slowing in the rate of credit expansion. While unwanted price increases threatened, the cooperative effort to hold the wage-price level undertaken by labor, industry, and the Government seemed to be working.

The critical forces which would determine price movements for the next several months appeared to be the relative expansion rates for total demand and potential output, expectations, and the success of the President's price and wage programs. Price movements of the past year could be considered as normal and logical given the rapid rate of expansion. They offered no evidence as to how prices might react in a period of steady expansion at full employment.

Most projections of demand and supply available when the Board made its decision were in balance. In all forecasts, however, a recognized critical problem was inexact knowledge as to next year's growth rate for Federal expenditures and revenues. Depending on growth in the Federal budget, the country's demand might expand either more slowly or somewhat faster than capacity.

The Federal Reserve had no special information as to likely changes in the budget. Since, in attempting to formulate a correct policy for next year, the budget figures are critical, it seemed to me improper to make a drastic monetary change until this information became available. Re-enforcing this reasoning was the fact that although a one-month delay was technically feasible, an increase in discount and interest rates would be irreversible for a considerable period. The arguments for immediate action seemed weak.

The Need for Coordination

A more significant reason for urging a delay than incomplete information was my belief that this action failed to give sufficient weight to the necessity for a proper coordination of fiscal, wage-price, and monetary policies.

It would be interpreted by many as an attack by the Federal Reserve on the national consensus or program for meeting price pressures. Some would feel that the Board was assailing recent governmental policies. Others would assume that the Board did not accept maximum full-employment growth with stable prices as a national goal. Raising the discount rate would be interpreted as a view by the Board that because full employment increases inflationary problems, restrictive monetary policy must be invoked at its mere approach.

More important, I felt that a failure to coordinate was an irresponsible use of our independence. It reduced the choices on national policy available to the President. We were informing him that monetary policy would be tighter, leaving him to adjust fiscal and wage-price policy accordingly.

Many people recently have argued that the country can achieve a proper level of total demand by a policy of high interest rates offset by high budget deficits. They point out that each dollar of demand curtailed by higher interest rates can be offset by a budget deficit. As a fiscal conservative and a believer in leaving the maximum of choices to our market economy, I dislike this theory.

I personally think that in the current situation, adjustments through fiscal policy might be more advantageous. The country may be better off with lower deficits and lower interest rates. If demand is great enough, we may need a budget surplus. Increasing interest rates primarily penalizes growth and improvements in urban life. It tends to restrict modernization of plant and equipment, growth in housing, and the expansion and rebuilding of vitally needed State and local improvements. It increases the Federal deficit. It makes the task of the small businessman more difficult.

But more important than my own beliefs is the fact that I dislike attempting to impose them unilaterally on other parts of the Government. I would have preferred to explore all possible channels in an attempt to get a coordinated program. The Board's freedom to act requires that it use responsible statesmanship in achieving better economic policy.

History has shown that dividing the monetary from the fiscal functions of government is wise. Otherwise the creation of money to fill the public purse can become an engine of inflation. Because the Federal Reserve has a unique responsibility for maintaining monetary integrity, we must work as hard as possible to make certain that it is used properly.

The costs of conflict between monetary, fiscal, and wage-price policy are high. Achieving sound policies which will enable our economy to grow with stable prices at full employment is a most difficult task. In such decisions, the Federal Reserve System has a vital role. It must remind other agencies of the need for monetary probity and must insist that the value of the dollar be maintained. However, our independence and right to act should be used primarily as a valuable ace in the hole. An unnecessary use of power may dangerously weaken the System. The weapon of independence is clearly a major bargaining force. However, because monetary and fiscal policies are necessarily interdependent, national goals may more easily be achieved if the ability to act leads to a coordinated program rather than independent action. Weapons held in reserve may be more powerful than those committed at the earliest sign of conflict.

It also seemed clear that a precipitate action by the Board in the light of recent history would decrease its hoped-for deflationary impact. People might mistakenly believe that the action was taken on far firmer grounds than it was. They might assume that the Board was convinced that inflation was imminent. This sudden action could easily cause a rise in expectations and a sharp run-up in demand. Others might not understand the significant difference between banks raising their prices and unions and other industries doing likewise. They might feel justified in demanding higher wages or prices.

To some people's surprise my views on the requirements for evaluating the total (both direct and side-effects) results of this interest rate action have been highly influenced by Senator Robert Taft. As a member of your Committee, he pointed out on numerous occasions that tax (and by implication, interest) increases have three separate influences. (1) Demand is decreased, thus tending to reduce prices. (2) Costs are raised, tending to raise prices. (3) The changed situation (announcement effect) may lead to independent price increases.

Most people concerned with the discount change stress only the first factor: that is, that higher interest rates make credit more expensive. People decrease their desires to purchase equipment, plants, houses, autos, etc. The lowered demand for goods means a lowered demand for employment. There is less pressure for wage and price hikes.

In addition though, we all recognize that interest is a cost of doing business. Gross interest payments in this country total about $70 billion a year. Raising a cost must have some influence on prices.

The announcement effects are expected to be mixed. However, any procedures that raised expectations or decreased the ability of the Administration to maintain its wage-price guidelines would diminish the desired price influences.

It seemed clear to me that the method used by the Board of raising the discount rate failed to coordinate monetary, fiscal, and wage-price policy. It was bound to increase the undesired price-increasing side-effects at the expense of the hoped-for deflationary impact. A delay of a month to enable the Government to announce a unified policy would greatly increase the effectiveness of the Board's action.

Improper Reasons

I am also concerned because it appears to me that the reasoning and action of the majority tend to enthrone as causes for monetary restraint two pieces of theory which I feel are invalid and dangerous precedents. These are: (1) the continuing use of higher interest rates in the United States economy for balance of payments purposes; and (2) the concept that one must act in advance of changes in demand for fear that once demand starts to grow it can be contained only with much higher sacrifices.

I have previously stated my views on the balance of payments argument. The United States is doing extremely well in restraining interest-sensitive items through present programs. Further rate increases might simply be matched again overseas. Indeed, higher rates may have a perverse effect. United States interest payments abroad would rise immediately. Higher financing costs would make our exports less competitive. Slower growth in this country might make direct investments abroad--our chief problem area--look even more inviting.

The traditional belief in higher interest rates for balance of payments reasons assumes either (1) rates high enough to raise unemployment sufficiently to curtail imports or (2) interest high enough to change capital flows. No one admits to desiring the first path. The second path I regard as dangerous and almost impassable.

When the discount rate was raised, the President was in the process of announcing a revised balance of payments program designed to bring about the necessary return to equilibrium. I believe the President's program was proper and sufficient. The constant use of balance of payments as a theme to raise interest rates can only have a most unfortunate long-run impact.

I am not certain I understand the argument that it was impossible to delay action for a month or until sufficient information about demand, prices, and credit became available. This is contrary to what we know about most decision processes. As I understand this reasoning, it holds that delays and small infusions of additional credit are extremely dangerous. They lead to highly magnified inflationary conditions in the future. The use of credit gains momentum and runs away after some critical point.

We must admit that anything, including such results, may be possible. However, most people who have studied our monetary system carefully believe such a situation is extremely unlikely to occur. A large-scale credit expansion without added reserves would require peculiar types of discontinuities in our monetary system. There is no indication they exist. They have not appeared in the past. I spent considerable time trying to track down the basis of this idea. No one I asked on our staff or among monetary historians or theorists could find any support for this doctrine.

I concluded that neither the idea of a critical mass of credit nor the balance of payments argument was a proper basis for policy decisions.

The Method of Curtailing Credit Expansion

When it became evident that a majority of the Board felt that a curtailment of credit was desirable, a question arose as to the best method of procedure. This is clearly far more a question of judgment than of analysis or of values. I felt that an immediate discount rate change should be avoided. The Board has had an established policy of letting discount rate changes follow the market. It has stated that it rarely deviates from this policy unless it desires to stress the importance of the change and to obtain a magnified effect. The disadvantages of decreasing credit at this time seemed sufficiently great. I saw no special circumstances requiring a break with traditional policy.

In addition to all other disadvantages, the rate change method together with the change in Regulation Q, made it possible that the level of credit and demand would be raised rather than lowered. The System would have to furnish additional reserves for the transition period. A shift from demand to time deposits would mean that the existing reserve base could support a credit expansion. As a result, the action would bring higher interest rates, but at least initially an undesired increase in real demand could occur.

Given the expressed desire to curtail credit rather than to ratchet the interest rate structure upward, a more traditional and simpler approach appeared preferable. The System could simply determine not to furnish additional reserves and not to raise Regulation Q. The discount window could have been opened wider to meet urgent needs. Borrowed reserves have been low by past standards for periods of restraint.

Tighter money and larger borrowed reserves would have led to higher rates which could then have been ratified by a later discount rate change. This would have avoided the uncertainties and misunderstandings of the present situation. There would have been time for coordination with the fiscal authorities. If no agreement was possible, there at least could have been an announcement of a joint agreement to disagree.

Mr. Chairman, this concludes my statement. I want to make it clear again that while I believe the discount rate change at this time was incorrect policy, it is a move that can and will be absorbed by the economy without causing an immediate recession.

We must recognize our limited experience in operating for any length of time at full employment. However, the potential gains to our national welfare from the successful development of policies that will allow rapid expansion with stable prices are enormous. I hope that we can think of this action as behind us. Now it is time to try again to work out a better coordinated use of all types of policies which can help in achieving our national goals.