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FORMULATION OF MONETARY POLICY

At a time such as this it is imperative that we take another look at our economic picture -- past, present, and even the future, insofar as this is possible. We all recognize the vital importance of maintaining economic stability at a high level of production and employment in order to succeed in our efforts to build a strong defense for world peace and to succeed in our efforts at the United Nations for disarmament for world peace.

As we know, the large wartime growth in liquid assets provided the underlying basis of the inflationary threat which haunts not only the present defense economy but has been a real threat to economic stability over most of the past decade. A renewed upsurge of these inflationary pressures occurred with the outbreak of the Korean war. At that time production and employment were at record peacetime levels with total national production in the second quarter of 1950 running at an annual rate of 275 billion dollars and non-agricultural employment amounting to almost 44 million. Unemployment amounted to only slightly over 3 million. In steel, automobile, non-ferrous metals and other key industries capacity was highly utilized. Credit was expanding rapidly with bank loans in the year preceding Korea rising almost 5 billion dollars. Prices were moving upward with the Consumer's Price Index advancing from about 168 in January 1950, to over 170 in June; and the wholesale price index rising from 151 to 157 in the same period. This was a vastly different situation from that existing at the beginning of the World War II period. In the second quarter of 1939 our total national product was 89 billion dollars on an annual basis, non-agricultural employment was under 30 million while some 9 1/2 million people were still unemployed. The Consumer's Price Index stood at 99 and the wholesale price index at 76. There was thus much apparent room for expansion.

Our action to repel the Korean invasion as well as the urgent necessity for strengthening our defenses unleashed a sequence of inflationary developments. Initially, in the second half of last year, increased expenditures for goods and services were made largely by private individuals and corporations rather than by public agencies. Consumers reacted to the renewed world crisis by expanding purchases in anticipation of shortages and price advances. Businessmen increased their orders for inventories and sharply revised upward their programs for expansion of plant and equipment. Anticipatory buying forced up the prices of many basic materials. From the second quarter of last year to the first quarter of this year private spending increased at an annual rate of 31 billion dollars while governmental spending was up by only 13 billion. To some extent these private expenditures were associated with the needs of the defense program, but nevertheless the major immediate factor in the inflation was the expansion of private, nondefense demands.

Under the pressure of these greatly enlarged demands, basic commodity prices in the first month after Korea advanced 12 per cent and wholesale prices 5 per cent. A cumulative upward spiral of prices, wage rates, incomes, and expenditures was set in motion and continued until the spring of 1951. Basic commodities showed an average increase of about 44 per cent, and consumer prices increased about 9 per cent in this period. Consumer and business incomes increased sharply with the expansion of employment, output, prices, and wages. Personal incomes increased by about 12 per cent while corporate profits before taxes also rose sharply to a new high during this period. The growth in the current income of consumers and businesses was supplemented by increased use of liquid assets and credit to add substantially to the inflation process.

Thus we were in a situation that required provision for the tremendous needs of the defense program while at the same time requiring the restriction of inflationary pressures. Production had to be greatly expanded, and nondefense demand for goods and services had to be restricted to match the output of goods and services available after defense requirements had been met. These were the issues facing the economy. These were the factors that required evaluation by the Federal Reserve System in terms of the over-all monetary and credit policies that would be appropriate for the occasion. The general problem was one similar in kind, if not in degree, to that constantly being faced by central banking institutions: how to adjust monetary and credit conditions to current changes in the economic situation? The short run problem was (and is) not only the adjustment of monetary and credit policy so that it did not in itself contribute to economic instability but also the formulation of policy which would help to counteract or compensate for unstabilizing forces.

Interrelation of Monetary and Fiscal Policy

Credit and monetary policy alone does not afford a solution for all our economic difficulties. It cannot offset all the destabilizing forces in the economy, and thus it requires the aid of fiscal policy and other governmental action. Both fiscal and monetary policy can affect the aggregate demand, i.e. the total volume of spending, in the economy. Fiscal policy is primarily effective through its influence on the volume and kind of governmental expenditures on the one hand and the amount amd kind of taxation on the other. Thus governmental expenditure may be directed at different segments of the community with varying results. Some expenditure such as public outlays on various free services such as roads, parks, education, and health programs may act to increase private consumption. On the other hand the outlays may be for investment purposes such as resource development, public housing programs, and Government lending to finance private housing, rural electrification, and various forms of private industry. The development of such expenditure programs brings up familiar but pertinent questions. How far may such expenditures expand without coming into competition with private industry? If Government expenditures are designed to be non-competing with the private sector of the economy, how far can they expand before the social benefits of such expenditure diminish greatly -- especially when compared to the alternative use of these funds by the private sector? It is also true that many potential areas of Government investment do not readily lend themselves to the abrupt changes necessary in a flexible stabilization program. The spigot is not readily turned on and off.

The amount and kind of taxation is especially significant as the burden of over-all taxation in the nation grows and tax rates again approach or pass their World War II peaks. Taxation acts not only to reduce personal incomes, but as you know the combination of taxes and expenditures also results in a redistribution of total income after taxes. The progressive personal income tax is especially important in this connection. Such a redistribution of income results in a change in the pattern of private buying and spending and in this respect is similar to excise taxation which also affects the pattern of consumer expenditure. The problem of timing is important in taxation as well as in expenditure and the recent session of Congress indicates the amount of time necessary to obtain passage of tax legislation. Some taxes such as the income taxes, however, have "built-in-flexibility" which provides some stabilization effects through yield changes as levels of income fluctuate. It should be noted here that these fiscal devices are similar to general monetary policy in that they are measures taken by public authorities. In both cases they affect private spending through the market mechanism and thus operate in an impersonal fashion.

Fiscal policy may be used to restrain inflation through the reduction of Government expenditures or the increase of taxes, or both. The most direct and effective way to curtail inflation is through taxation. Taxation also makes people conscious of Government expenditure and the purpose of such expenditure. Taxation tends to reduce the amount of disposable income available for private expenditure and thus helps to prepare an economic climate in which monetary and credit policy can be more effective. As taxes climb higher, however, the question of how high our taxation can go without impairing the functioning of our free enterprise system becomes more and more significant. Also, some taxes themselves may be added to costs and thus be reflected in higher prices to consumers and in the price indexes which are used as criteria for further wage increases.

It is therefore evident that monetary and credit policy and fiscal policy must be directed to the same objectives in order to avoid offsetting each other and also in order to maximize their effectiveness in facilitating the attainment of stable economic progress. The combination of fiscal and monetary policy that is most desirable at any particular time will depend on the existing economic situation as well as the practical feasibility of various actions. Credit and monetary policies and fiscal policies are both complementary and mutually supplementary instruments of public policy which must be used together to assure stable economic progress.

The Functions of Monetary Policy

Keeping in mind these important relationships of monetary and fiscal policy, let us now turn to a more careful examination of the functions of monetary and credit policy. The objective of monetary policy is the maintenance of the amount of credit and money in the economy that will contribute to stable economic progress at high levels of production and employment. All of the various instruments of the Federal Reserve are directed toward this common broad objective. Each instrument, however, operates through different channels and is designed to accomplish somewhat different specific objectives.

The principal tools available to the Federal Reserve for accomplishing these ends are the following: (1) Open market operations which serve to affect the volume of bank reserves at the initiative of Federal Reserve authorities. In recent years they also have been used to contribute to the maintenance of orderly markets for Government securities; (2) Discounts and advances to member banks which allow member banks on their own initiative to make necessary short-run adjustments in their reserve positions; (3) Reserve requirements which are established within statutory limits by the Board requiring member banks to hold certain reserves relative to deposits; (4) Selective credit controls which are designed to affect credit in particular areas without necessarily affecting the availability of funds in other areas; and (5) Supervisory activities, direct suasion, and voluntary programs designed to influence lending activities in general or in particular credit areas. The first three instruments -- open market operations, the making of discounts and advances, and the setting of reserve requirements -- are impersonalized stabilization tools. They operate through the market mechanism of the private economy and in this way affect spending.

Some of these monetary instruments may affect the total volume of money and other liquid assets. Changes in policy thus affect the amount that the economy as a whole has to spend. Other policy instruments may influence the total volume of spending by affecting that part which is financed through credit extension. Their effect is usually general and indirect with the immediate impact falling on the cost and availability of credit.

As security analysts, you know that monetary influence on the volume of spending is also exerted by upward or downward pressure on the value of marketable assets. Such pressure affects the amounts that various investor groups would receive for their assets. For example, an increase in yield from 2 1/2 to 2 3/4 per cent on a 20 year 2 1/2 per cent security involves a decline in price from 100 to slightly over 96. It thus may affect investors' readiness to sell assets in order to obtain cash and thus tends to reduce their propensity to spend.

Another method of influencing spending is through the regulation of terms under which borrowers obtain credit. Thus special regulations apply to loans on stock exchange collateral, consumer credit, and real estate credit -- types of credit which lend themselves to standardized patterns that can be singled out by statute for regulation. The raising of margin requirements to 75 per cent in January of this year limited the amount of credit that can be extended on listed securities. From January to August of this year customers' debit balances have declined 150 million dollars. In September these balances totaled 1,290 million dollars. The regulation of consumer credit through Regulation W has exerted a definitely restraining influence -- instalment credit outstanding was reduced by half a billion dollars from October 1950 to July 1951. The Board's Regulation X covering down-payments and maturities in the real estate field has been increasingly effective throughout this year. In the third quarter of this year housing starts were below the level of a year ago by over 35 per cent.

Finally, as you well know, monetary policy helps to determine the general financial climate of the nation. When the money market (i.e. credit and money) is "easy", the effect is the establishment of a favorable

financial climate for the expansion of business, investor and consumer expenditure. If the market is "tight" -- the financial climate is less favorable -- the tempo of spending activity is dampened and caution appears in sensitive business areas.

These pressures and influences on the volume of spending when applied in an appropriate fashion make their contribution to the attainment of a stable and smoothly functioning economy. In the light of any given economic situation, however, such as the aforementioned inflationary impact of the defense economy, appropriate action demands flexibility of policy so that changes in economic conditions can be met as quickly as possible. Likewise, in order to achieve long-run goals, an informed, watchful, neutral policy is very important and, for obvious reasons, at times very difficult.

This brings us back specifically to the problems occasioned by the Korean War and the development of a defense economy -- a period when there were many questions to be answered and steps to be taken.

Credit and Monetary Policy in the Defense Program

At the risk of being repetitious, I feel it is necessary and important to review at this time what has happened in the fight against inflation. On the basis of this broad sketch of the role of monetary and credit policy in our modern economy, what actions were taken to develop an anti-inflation program? Some criticism may be levied against the program because some actions were not taken more promptly or more vigorously. It should be recognized, however, that the problem of reconciling security and private demands were, and are, much more difficult than at the start of World War II. There were inevitable lags in shifting from a normal peacetime to a defense economy. Congress acted with considerable dispatch in the case of some programs. The Defense Production Act was approved in early September 1950, and some of the curbs permitted by that Act were in operation in October. A variety of financial actions designed to reduce spending for nondefense purposes were necessary, and many of these have been taken. Non-financial controls such as the materials allocation program and price and wage control have acted to relieve and limit pressures on prices.

General credit measures designed to limit the supply of lendable funds available -- particularly to banks -- have been used with considerable success. These measures include changes in discount rates, in open market operations, and bank reserve requirements. As you will remember, in August 1950, the Federal Reserve Board and the Open Market Committee issued a joint statement indicating that they were prepared to use all available powers to restrain further expansion of bank credit consistent with a policy of maintaining orderly conditions in the Government securities market. Discount rates were increased from 1 1/2 to 1 3/4 per cent. Open market operations were so directed as to reduce System purchases of Government securities and thus limit the availability of reserves to banks. As a result of these operations, short-term rates rose slightly. However, the System continued support of the long-term bond market which tended to offset the effectiveness of these policies. Federal Reserve purchases of securities in these support operations were only partially offset by sales of other issues in the market;

and as a result, bank obtained additional reserves which provided the basis for further bank credit expansion.

Some of these additional reserves were absorbed in January 1951, by an increase in member bank reserve requirements. For banks that did not have excess reserves, however, this necessitated the sale of Governments in order to obtain the required reserves, and this in turn placed pressure on the securities market and thus required buying by the Federal Reserve.

Last spring, however, the Federal Reserve adopted open market policies to minimize monetization of the public debt while maintaining orderly conditions in the Government securities market. Since then the Government bond market has functioned more nearly as a normal market mechanism without Federal Reserve support except for temporary operations to facilitate Treasury refundings. Reduced availability of credit in the face of insistent credit demand necessarily implies a somewhat higher level of interest rates in various sectors of the market. Taking April as a base, short-term interest rates since then have ranged from 1/8 to 1/4 per cent above that level but at the present time are near the levels that prevailed at the end of April. Long-term rates have followed the same general pattern of flexibility.

In addition to these general controls, the selective controls which I have already mentioned have exerted an important anti-inflationary influence in key markets. Instalment credit has been reduced and the mortgage market has tightened in response to Federal Reserve activity.

In this situation voluntary credit restraint or lender cooperation has also played an important part. This program is a striking illustration of the way in which a complex voluntary effort can be successfully organized to keep lenders and borrowers, public and private, constantly informed about and alert to monetary and credit conditions and help evaluate loans which are nonessential and should be curtailed.

In addition to these shifts in credit and monetary policy, the nation in the period of a year was subjected to a much heavier taxation program. In order to meet rapidly mounting defense expenditures and curtail inflationary pressures, unprecedented tax increases were necessary. In a period of a few months, Congress adopted taxes designed to add some 10 billion dollars on a yearly basis to Federal Government receipts. This was accomplished by the Revenue Act of 1950 and the Excess Profits Tax of 1950. The President has recently signed the Revenue Act of 1951 which will add some 5 billion dollars more annually to receipts. Individual income tax rates are now near the peak levels reached during World War II. Corporate income tax rates for most corporations are at new highs, and these recent increases plus excess profits taxation have sharply increased the over-all corporate tax rates. These increased taxes have meant that private income after taxes and thus private demands have been substantially less than they would otherwise have been.

The effectiveness of such monetary and fiscal policies as well as nonfinancial restraints is always difficult to measure because it has to be appraised in terms of what would have occurred if the policies had not been adopted. There is definite evidence, however, that these anti-inflationary programs together with other nonfinancial programs have had marked

beneficial effects. Prices of basic materials are well below their earlier speculative peaks, wholesale prices generally are moderately lower, and consumer prices have shown little change since spring. Despite further increases in personal income, there has been a noticeable slackening in consumer demand from the extraordinary levels reached earlier in this period. Personal saving has risen to the highest level since the end of World War II. In recent months liquid saving in the form of time deposits and saving and loan shares has increased markedly. Production has been maintained at high levels and, with consumer demand slackened, readjustment to defense production has been accelerated. We have also made great strides toward the achievement and maintenance of military might. The defense program has made important progress toward establishing and equipping a military force of about 3 1/2 million; providing a stockpile of critical materials and sufficient military material for near term needs; establishing a large production potential in basic and defense industries; and toward supplying other free nations with some armament for their armed forces.

Prospective Developments in Credit and Monetary Policy

With these events and real achievements behind us, it seems proper now to consider at least some of the problems of the future. From an over-all point of view the events of the past six months have formed a mixed pattern of demand and price developments. Thus, although defense expenditures rose at an annual rate of 12 billion dollars from the first to third quarters of this year, non-defense expenditures, mainly private, dropped by almost 5 billion.

The current economic situation, as I have said, is essentially one of stability at very high levels of production and employment. The gross national product has been holding at an annual rate of roughly 325 billion dollars for the past two quarters while personal income has increased only slightly -- from an annual rate of 250 billion in the second quarter to about 253 in the third quarter. Consumer prices have remained relatively stable since spring at advanced levels about 9 per cent above the pre-Korea level. Wholesale prices have been fairly stable at a level about 4 per cent below the March 1951 peak but still 13 per cent above June 1950 levels. The prices of basic materials, which rose very sharply from the summer of 1950 to the early part of this year, declined considerably from March to July and then showed little change to mid-September. Since then prices of some materials, especially metals, have returned to or close to their peak levels. Non-agricultural employment has remained stable since March -- holding roughly to a figure of 46.5 million.

Soft spots have developed in some areas of the economic scene, especially for household durable goods such as appliances and furniture. Also production of leather, textiles and some other nondurable consumer goods out-stripped demand, inventories of these goods accumulated and are now being reduced. There have been pronounced efforts on the part of business to reduce excessive inventories in many consumer lines.

Does the development of these and other soft spots mean that inflationary forces are spent and that we can relax our vigilance and shortly dispense with part of our anti-inflation weapons? This is the

short-run problem that we face. The President, in his speech last night, warned that a crisis still exists when he said: "In making our proposal for reducing armaments, we are not suggesting that the crisis in world affairs has passed, or even that it has lessened. It has not. We cannot afford, for one minute, to let down our guard, or falter in our defense program".

Even if the disarmament plan is eventually successful, it will take a long time to implement such a program. Thus it is necessary to look beyond the immediate situation to the basic forces which will shape the nation's economic development for the next few years. As we understand it, our national security program goes beyond the immediate requirements of Korea. Expenditures for this program, including foreign aid, have increased from an annual rate of 16 billion dollars just preceding Korea to one of about 40 billion for the quarter just passed. The Third Quarterly Report to the President by Director of Defense Mobilization Charles E. Wilson estimated that defense expenditures would rise by another 25 billion in the coming year and would increase still further thereafter. For example, production of aircraft doubled in the past year, but it is expected to increase 4 to 5 times more than present levels in the next two years. Large increases in deliveries are also scheduled for tanks, guns, ammunition, and for highly complex and expensive electronics equipment. Outlays for defense purposes now take about 13 per cent of total output, and a year from now are expected to take 18 to 20 per cent of an even larger total output. The increasing needs of the defense program will probably require continuing very large outlays for plant modernization and expansion.

Business expenditures for plant and equipment are currently at record rates. Some estimates for 1951 place the total in excess of 25 billion dollars as compared to 18.6 billion for 1950 and 19.2 billion in 1948, the previous peak year. Much of this great volume of expenditure represents expansion of plant and modernization of facilities in defense industries such as iron and steel, railroads, petroleum, and utilities. The rising volume of defense expenditure and large business expenditures for plant and equipment have been and may well continue to be major expansive factors in the economy.

The additional defense output will also generate additional personal income after taxes, and this larger income may find expression partly in greater demand for civilian goods. Although most goods are in ample supply, acute shortages of steel, copper, aluminum, and other basic metals persist. These shortages have resulted in orders limiting their use for production of many consumer durable goods. Although restrictions on the scale required during World War II are not anticipated, some additional curtailment of civilian supplies of metal products is in prospect. Thus on the one hand is the prospect of somewhat limited supply of some items and on the other the additional demand potential arising out of higher personal income.

The danger of increased consumer demands arising from this source may be intensified in view of the recent unusually high personal saving rate. Personal savings amounted to about 11 billion dollars in 1950 and in the second quarter of 1951 were at the high level of 21 billion dollars on an annual basis. In recent months individuals have been saving more than 9 per cent of their current income after taxes. This is an unusually high

proportion and compares with an average of about 4 per cent in the period 1947-50. If consumers spend a more customary proportion of their income, inflationary pressures will be still greater.

Thus on the basis of these factors it appears that the economy is still threatened with the recurrence of inflationary pressures even if the volume of defense expenditure is reduced moderately. Both consumers and businesses are in strong financial positions, and this together with expected increases in income could readily support new buying surges or more gradual increases to higher expenditure levels.

Under present circumstances basic economic policy must still be directed toward maintaining economic stability in a strife-ridden world. It seems to me, therefore, that the Federal Reserve System take this longer-run view while dealing with the current situation. This is in the long-range public interest.