Outline of Remarks
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Credit and Monetary Policy

I. This is a particularly appropriate time to consider the objectives of credit and monetary policy: sustained economic growth and a stable value for the dollar.

A. The rapid rise in production in 1955 (industrial output increased 11 per cent during the year) brought economic activity to capacity levels in many lines.

B. As capacity output was approached, industrial prices began to creep upward (at the wholesale level they have risen more than 5 per cent since mid-1955).

C. At the same time business was expanding substantially its inventory purchasing and indicating that it planned very large increases in plant and equipment expenditures. Consumers also revealed considerable optimism in their income and spending expectations for this year.

D. Under these conditions, it became the task of credit and monetary policy, by influencing the availability and cost of credit, to encourage the continued growth made possible by rising productive capacity while restraining tendencies toward inflationary price developments.

II. Policy formation in the field of money and credit is seldom guided by clear unequivocal signposts. Two examples:

A. Until recently, wholesale prices of farm products were declining while wholesale prices of industrial commodities as well as construction materials were rising. To the extent that credit and monetary policy looks to price trends for guidance, should it have been guided only by the index of consumer prices (which remained virtually unchanged since mid-1955) or only by the wholesale price index (which rose about 4 per cent over-all -- taking into account agricultural as well as industrial prices)?

B. In recent months automobile production has declined about one-fourth from last year's extraordinary level and housing construction has also fallen off somewhat. But many other lines have continued to increase at capacity levels and over-all production has remained generally stable. Would today's output be higher if credit had been more readily available in the past few months? In view of the pressure of demand against capacity in many industries, what would have happened to prices if monetary and credit policy had been easier?

III. Policy formation must take account of lags in the process by which Federal Reserve action is transmitted through the credit and capital markets to ultimate expenditures for goods and services.

A. The initial impact is usually on the unborrowed reserve position of member banks (or net borrowed reserves, if member bank borrowing exceeds excess reserves).

B. Bank lending and investing is encouraged or discouraged by this impact and market interest rates tend to fall or rise.

C. The effects tend to spread to other lenders with lags that vary as among lenders and from one situation to another.

D. Thus, at all times, policy changes need to be adapted as promptly as the indications of comprehensive economic and financial information suggest, sometimes before complete data are available, and perhaps before there is widespread public recognition of the situation Federal Reserve action is designed to correct or prevent. These policy adaptations on the basis of early information must be tentative. As further information confirms the direction they have taken, they become more positive. Accordingly, there is a usual gradualness about policy shifts.

IV. Federal Reserve policy instruments are adapted to flexibility of policy.

A. Open market operations are by their nature the most flexible instrument.

1. Changes in the direction or intensity of policy can be undertaken gradually, and the results can be observed for guidance as to further action.

2. Seasonal requirements for credit and money can be met without necessarily altering the underlying policy.

3. Because of the importance of Government securities in the portfolios of most financial institutions, changes in prices and yields on governments induced by open market operations are likely to have direct effects on credit policies of lenders other than commercial banks in addition to their impact on member bank reserves.

B. While open market operations are the most flexible instrument, they are used in close combination with rediscount policy, and neither can be discussed in isolation.

1. The volume of member bank borrowing tends to reflect open market policy.

a. If reserves are being supplied through open market purchases, member banks tend either to reduce their borrowing or to refrain from borrowing from their Reserve Banks.

b. If credit demands are strong and reserves are not provided, or are withdrawn, through open market operations, member bank borrowing tends to rise and banks, because of the indebtedness they have incurred, become more reluctant to lend and invest.

c. Discount rate policy may be used to encourage or discourage member bank borrowing and thus to reinforce the effect on bank loans and investments. Discount rate changes are likely to be accompanied by changes in levels of interest rates in the credit and capital markets generally, and thus to be widely reflected in the cost of credit.

V. During the past year, credit and monetary policy has been characterized by restraint in the face of boom conditions in most goods markets and strong demands in credit markets.

A. As production, responding to rising demand, rapidly approached capacity in the course of 1955, Federal Reserve policy gradually shifted toward moderate restraint on the rate of bank credit expansion.

1. In the face of rising demands for loans, commercial banks found it necessary to relinquish Government securities and to take the initiative in raising the amount and frequency of their borrowing from the Federal Reserve Banks.

2. Further restraint was exerted by the five increases in Federal Reserve Bank discount rates, which rose from 1-3/4 per cent at the beginning of 1955 to 2-3/4 - 3 per cent at present.

3. Thus the money supply -- demand deposits and currency in the hands of the public -- rose about $2 billion, in the 12 months ending April. Commercial bank loans, however, increased $12 billion. The difference was accounted for primarily by $8 billion of bank sales of securities. In other words, $8 billion of funds, which might otherwise have been retained in cash balances available for spending, were used by other investors to purchase securities relinquished by the banks.

4. The rise in interest rates in all credit markets over the past year, which reflected both increased demand for funds and some restriction of supply, also played a role in reducing or postponing some borrowings that would otherwise have occurred.

VI. Of the alternative means of fostering greater economic stability available to government, credit and monetary policy has the great advantage of flexibility. It can be closely geared to changes in the economic situation and climate; in fact, its function is to limit and cushion those changes so that a financial environment favorable to orderly progress is constantly maintained. It follows that:

A. As long as over-all demands are strong and continue to press against capacity, it is the unavoidable task of policy to prevent such demands from exerting inflationary pressure, while encouraging growth within the limits of expanding capacity to produce.

B. As growth in over-all demands slows down in relation to potential output, credit and monetary policy is modified accordingly, early and promptly, to facilitate continued and sustainable growth in the economy.

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