THE EFFECTS OF FEDERAL RESERVE POLICY

(Address of C. Canby Balderston, Vice Chairman, Board of Governors of the Federal Reserve System, at the Executives Forum on Economics of Banking and Monetary Policy, sponsored by the Miami Chapter of the AIB, February 4, 1957.)

The preamble of the Federal Reserve Act describes it as "An Act to provide for the establishment of Federal Reserve Banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States."

A third of a century later, the Congress set forth in the Employment Act of 1946 "that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy - - - to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining - - - useful employment opportunities - - - for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power."

From these statements, and indeed from the voluminous legislative record covering both the enactment of and amendments to the Federal Reserve Act, one may distill the basic principle governing operations of the Federal Reserve System: its responsibility to foster orderly economic growth, full utilization of our productive resources, and to protect the stability of the dollar. The System seeks to achieve these goals by influencing the behavior of credit and money. To decide what monetary actions at any given moment will best promote these broad objectives is the essence of Federal Reserve policy determination.

Some of the questions that arise when one seeks guideposts for these policy decisions are well expressed in ABA Monetary Study No. 4, on "The Effects of Federal Reserve Policies."

(1) In considering the effects [of open market operations] on the money supply, how should one decide what constitutes the "right amount" of credit for the country at a particular time?

(2) In considering the effects on the availability of credit, how should one decide the proper degree of tightness or ease that is desirable?

(3) In considering the effects on interest rates, how should one decide the extent to which rates should be permitted or encouraged to rise or fall at a particular time?

Such questions point up the difficulties of translating general objectives into concrete guides to policy. Is there not some formula for directing monetary policy that will avoid facing, day after day, these perplexing decisions? No such formula has been discovered, and one cannot be optimistic as to developing one in the future. If the economic system is now so complex that we cannot find easy solutions for the problems immediately before us, how can we devise any general prescription that will solve in advance the problems of the remote future. "In formulating a program of action, mechanical rules can not serve as a substitute for judgment. For several years, System officials sought rules or automatic guides to follow, but they could not find any which were appropriate for all circumstances. Operating guides must be chosen in terms of the problem posed by a specific situation and not on the basis of some mechanical rule-of-thumb." 1/

The determination of Federal Reserve policy then amounts to a continuing exercise in judgment--judgment based on direct knowledge of commercial bank operations derived from bank examination, judgment based on the best reporting we have been able to devise for assembling, analyzing and evaluating the wealth of economic and financial data now available, judgment checked by direct contacts of those in the Federal Reserve System with regional business sentiment. Yet ~~You~~ you need not be reminded that human judgments may be fallible.

1/ "The Quest for Stability", Federal Reserve Bank of Philadelphia, 1950, p. 15

After these observations on the making of monetary policy, we turn now to our particular topic: the effects of Federal Reserve policies.

A general discussion of the channels through which these policies make themselves felt in the economy is effectively covered in the ABA monograph to which I have referred. Therefore, I will consider the effects of monetary policy in particular terms, rather than general ones. To relate monetary policy to the economic events of the recent past may portray more vividly how monetary policy really works.

However, let me assure you of my firm belief that monetary policy does have important effects and that it is a potent instrument for keeping the economy on the track of stable growth. Not many years ago this viewpoint would have met with little support among economists. Even today it would not be accepted unanimously. Because many economists believe monetary policy failed to cure the great depression, they ~~are~~ were disposed to relegate it to an unimportant position among measures for achieving economic stabilization. Theorizing about economic fluctuations was turned more toward "real" or "physical" factors. Financial analysis, the investigation of financial influences and their impact upon the course of economic events, fell into disrepute. The reason for this line of thinking was that, while money was available for lending, the incentives to borrow--or to lend for some purposes--were subdued. This was caused partly ~~due~~ by a breakdown in the quality of credit following earlier excesses and partly by many other factors that tended to prolong the depression.

By now our thinking appears to have come full cycle. This is largely due to the change in the economic climate which has restored incentives to borrow and invest, as well as to the wartime creation of excess money supplies. Part of the explanation lies in what has been accomplished here and abroad in applying financial controls in order to promote economic stability. In short, financial analysis is coming back into its own.

Professor Haberler of Harvard University presented a well-argued reassessment of the importance of financial factors in economic developments in a recent article. He concludes that monetary factors and policies do play an important role in maintaining stability, and that students of the business cycle have neglected monetary factors unduly. He observes that if, during depressions, bank runs and failures, and the loss of confidence in financial institutions could be avoided, then slumps would not be catastrophic. He adds that if, during boom periods, inflationary and speculative excesses were prevented, and if government budgeting were mildly countercyclical, then "cyclical instability would be damped down to moderate proportions." These are encouraging ideas; they add new confidence to our thinking about the effects of monetary policy.

In order to tie our discussion of the recent effects of monetary policy to the broad objectives already mentioned, I will focus it on two questions. The first is: "Has economic growth been orderly?" The second: "How well has the purchasing power of the dollar been protected?

Has economic growth been orderly?

What does orderly economic growth mean? How can we apply this concept to the economic events of a year, or of a month

One answer is continued increases in output commensurate with the expansion of population. But it implies more than that. Instead of merely making the old things on an enlarged scale, it implies new products, new methods of production, and a rising standard of living for our growing numbers.

When is growth orderly? The term conveys fairly steady growth that is sustainable and free from the seeds of a future reversal. It is the opposite of an economic expansion built on a foundation that will collapse under it.

How does orderly growth look? To gain it, what must be sought? What avoided? These, of course, are large questions, but we do know something about what orderly growth does and does not look like. It is not a perfectly steady rate of increase in output from month to month and from year to year. It means a goal of reasonable, not complete, stability in the general averages, not in individual prices. It means that the utilization of resources will be reasonably full.

Perhaps the more interesting questions relate to the orderliness of growth. This concept cannot mean that each type of economic activity grows at the same rate, and at an unchanging one. A two per cent rate of growth does not necessarily mean that the output of automobiles, shirts and bread increases precisely two per cent each year. It does not necessarily mean that business expenditures for plant and equipment grow at a steady two per cent rate, that inventories be enlarged, or rail travel increase two per cent each year. Neither does it connote that the debt of different classes of borrowers will rise at equal rates; nor that total debt will rise at precisely the same rate as output.

In an economy in which folks are free to make their own decisions about consuming and investing, and in which innovations are frequent, shifts in the composition of both spending and borrowing are bound to happen. What is needed is that total economic activity make reasonably full use of our productive resources while average prices are kept stable. This shifting composition of economic activity without unwholesome variation in the total is implied in the concept of "rolling adjustment".

A true rolling adjustment is one in which total output continues to show fairly steady, and noninflationary, growth while shifts take place in its component parts. Take the late 1951-52 period after the Treasury Federal Reserve accord, when the term first came into common use. We then had a large increase in national security expenditures associated with the Korean War. However, overall demand was kept within bounds by some fortunate offsets. Business spending to accumulate inventories declined. Consumers restrained their spending for durable goods and increased their saving. Flexible monetary policy was an important factor in achieving these results. (See chart of Post-War Monetary Developments.)

In late 1953 and 1954 we went through a modest recession. Government spending for national security was cut sharply, and this was reflected in a decreasing business outlay for new plant and equipment, as well as consumer outlays for durable goods. Inventories, which had risen during the preceding boom, also declined. This was a structural readjustment in the resources of the economy, and required that consumers and State and local governments increase their spending.

Monetary policy, debt management policy and fiscal policy were all used to this end. The financial climate was made favorable to expansion. Easy credit sparked a remarkable increase in the rate of house building. Consumers, encouraged by liberalized instalment credit, bought large numbers of 1955 automobiles, perhaps 1 million or more than they otherwise would have. Observing the renewed recovery, businessmen rebuilt their inventories, and trying to compensate for marking time in 1954, began a tremendous expansion of new plant and equipment. Tax rates were reduced by the Federal Government and the built-in stabilizers of unemployment aid and progressive income taxes came into play.

As these cumulative forces brought about an upturn that eventually pushed output near capacity, and as the demand for loans grew, the financial climate grew rapidly warmer. Credit, while expanding, became more expensive. This change, together with some shortages in materials, slowed down the rate of increase in expenditures for goods and services, especially those whose volume had ballooned chiefly as a result of easy credit conditions. Its effects upon residential construction, which had risen to an extremely high level, was especially evident, partly because ceiling rates of insured and guaranteed mortgages reduced the ability of this market to compete against other demands for funds available for lending.

More recently, the most potent expansive force has been business investment spending. Its rate has been so high as to bring its sustainability into question. The most important question is whether or not overcapacity is being created. If business makes decisions of inferior quality, investment may rise so high as to be a qualitative as well as a quantitative threat to stable growth

What is to be done to keep this type of spending and others in line with the total resources that we have available and in some reasonable relation to one another? From whence comes the overall discipline or guidance that can direct the economy towards a course of stable growth? This is where monetary policy comes in, of course, along with other powers of the Government that contribute to the cause of economic stabilization: debt management policy and fiscal policy. It is the task of monetary policy to help create financial conditions appropriate to the needs of the economy, to insure that financial conditions will point the way for businesses, individuals, governmental units to make the kind of spending decisions that are called for by the logic of our overall economic situation.

The effects of monetary policy are complex. They appear at various poi in the economy with differing time-lags. The effect of Federal Reserve actions on the overall financial climate may be relatively prompt and decisive, or it may be retarded. Its actions are felt in the central money market promptly and affect directly the decisions of banks and others operating in this market. The effects of monetary policy on mortgage lending are indirect and may be felt only after the laps of time. Actual construction of plants and houses may be ~~effected~~ influenced only after a still greater lag. Moreover, ~~T~~the effects of monetary policy are cushioned by the ability of borrowers to draw upon previously existing uninvested funds.

<u>How well has the purchasing power of the dollar been protected?</u>

I now turn to my second main question: "How well has the purchasing power of the dollar been protected?" Marked changes in the purchasing power of the dollar are inconsistent with stable growth. Depreciation of the dollar by general price increases results from a situation such as that of recent months, in which demands for new goods and services exceed the ability of the economy to make them available at constant prices. The excessive upward push of prices and wages by those business and labor groups that have the economic power to enforce their demands also accentuates the process of inflation.

Inflation is dangerous for more reasons than one. Many people do not seem to accept the lesson of history that inflation causes an unfair redistribution of wealth and disrupts the social and political fabric. What is more directly relevant to our present topic, however, is that inflation distorts the direction of economic activity and causes decisions to be based on assumptions that are likely to prove false. Thus, ~~it~~ they reflect~~s~~ cupidity and imprudence, and sow~~s~~ the seeds of recurrent instability. This is particularly true when inflation is so persistent as to be considered inevitable. ~~and thus makes the planning of the affairs of individuals and businesses imprudent.~~

The record of recent years for protecting the purchasing power of the dollar has certainly not been all that can be desired. Following sharp rises in prices in the early post-war years and during the Korean crisis, there was a brief period of overall price stability even though there were disparate movements within the general index. After mid-1955, however, prices rose substantially. Average wholesale prices rose ~~[illegible]~~ 6 per cent; consumer prices, 3 per cent. If this were our first encounter with inflation during our recent history, these developments might ~~give~~ concern us less ~~concern~~. But the recent changes must be added to those of 1946-48 and 1950-51. Taking the postwar period as a whole, one gains the impression of an intermittent, but relentless, depreciation of the dollar.

It is this cumulative price advance that makes our recent price increases so disturbing. Some feel that these increases will not be offset by downward price movement, and that ~~the latter~~ price rises follow a one-way street. During the moderate postwar recessions, with conditions of falling output and employment, average prices went down a little in 1949 ~~and~~ but not at all in 1953. Consequently, price increases, even relatively moderate ones, take on a significance that they might not have if people felt they could assume that there would be offsetting declines. Even relatively small price increases begin to seem important if added on to a succession of earlier ones.

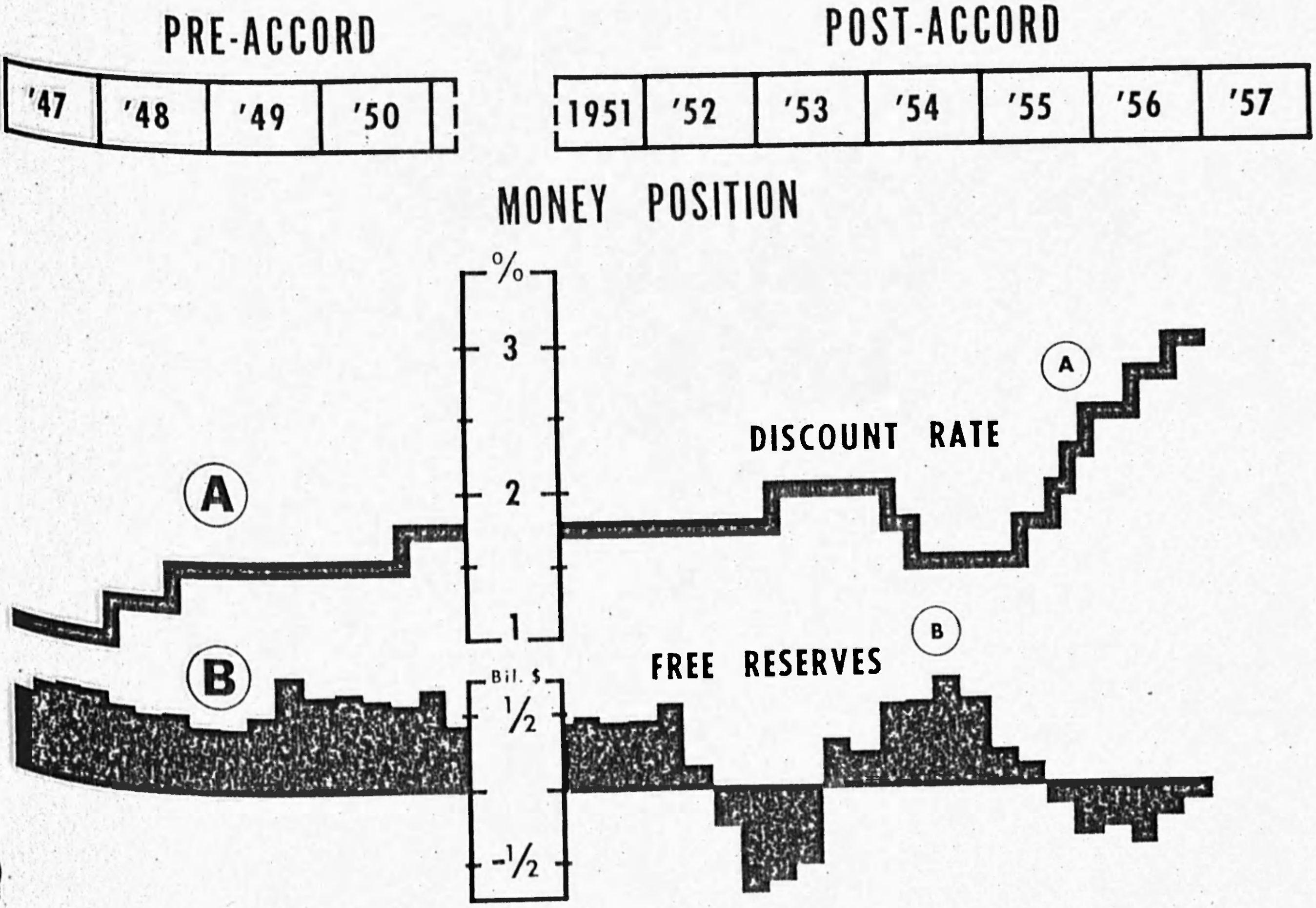
The second disturbing implication is that individuals and businesses might begin to make their decisions on the assumption that there will be a continued depreciation in the value of the dollar. Indeed, there are some signs that some of them already have begun to do so. Witness the growth of wage agreements containing escalator clauses. The disastrous consequences of a general acceptance of an assumption of continued inflation are so far-reaching as to be almost beyond calculation. Nothing could be more destructive of our hopes for growth that is stable. The purchasing power of the dollar has thus declined during the past year and a half, and its depreciation was of a magnitude to cause us concern.

What is the role of monetary policy in preventing inflation? It is clear that it cannot, by itself, cope with all aspects of the problem. Its job is to keep an undue expansion of bank credit from adding to inflation. Its job is to foster financial conditions consistent with the underlying economic situation, with incentives to invest and borrow, and the willingness to save. Its job is to see that, when inflation threatens, the appropriate storm signals to "take it easy on spending" and to be prudent are displayed. Sometimes it is said that restrictive monetary policy has been a failure because of imposing restraints on many desirable activities without preventing a rise in prices. This is surely an incorrect appraisal. When demand pressures for goods and money are vigorous, the feeding of additional credit into the economy could only have an inflationary result.

-- All of this means that ~~The~~ the duty of the central banker in safeguarding the integrity of the dollar may make him unpopular. To use an analogy of Chairman Martin, the central banker may need to remove the punch bowl just when the party is getting gay.

...s are for the 4th quarter, 1956; GNP has been revised since 1947 for 1956 p

POSTWAR MONETARY DEVELOPMENTS



OVER ALL EXPERIENCE OF ECONOMY