FOR RELEASE ON DELIVERY

(Approximately 12 noon EST,
Friday, April 5, 1957.)

CAPACITY, CONSUMPTION, AND STABILITY

Address of C. Canby Balderston,

Vice Chairman, Board of Governors of the Federal Reserve System,

at the annual meeting of

The American Cotton Manufacturers Institute, Inc.,

Palm Beach, Florida.

CAPACITY, CONSUMPTION, AND STABILITY

During this past year, credit has been described as "tight". The "tightness" has stemmed from sharp gains in the aggregate demand for credit rather than from a diminution in its supply. Actually, the supply of credit has increased a little over the year ago figure and has been used more efficiently. This is evidenced by the 8 per cent increase during the year in the turnover of demand deposits. While expansion has been restrained, the supply of credit has not been reduced.

As the demand for credit has forged ahead of the supply, the influence of the resultant scarcity has been felt in both the bond and mortgage markets. In turn, it has tended to curb residential construction and some state and local public construction, even though the latter continues in large volume. The extent of its impact on industrial expansion is more difficult to judge.

The mounting demand for funds has come from a variety of sources--governmental as well as private. The government has had to buy planes and missiles that require many of the same materials used in the building and equipping of plants for private industry. Corporations, indirectly, have competed in markets for basic materials with those individuals who desire new houses, cars, and household durables. As a result, inflationary pressures have centered largely in metals and metal products; these pressures were not confined to this country alone, but were world wide.

During this boom, the output of a number of commodities has been at or near capacity levels and there has continued a substantial expansion of plant capacity. The desire to expand plant has created additional demands for goods and services. These have been imposed upon an economy that was already using many of its resources to the full. The resultant competition for scarce materials, labor and credit has caused the prices of all of them to rise. By mid-March 1957, wholesale prices had pushed above those of mid-1955 by about 6 per cent and consumer prices by about 4 per cent.

This resume of recent economic events brings us to the role of monetary and fiscal policy. Their objectives are two-fold:

(1) To foster orderly economic growth and sustain employment at consistently high levels;

(2) To maintain the financial equilibrium of the economy, both internal, by protecting the purchasing power of the monetary unit, and external, by keeping international payments in balance.

These goals may be described in another way: to keep the economy running at high speed without overstraining its capacity. Only thus can our nation achieve economic progress in the form of more jobs and more goods combined with a dollar of stable buying power. To do this, a continuous stream of transactions must be kept running much like the stream of traffic on a crowded highway. This highway stretches ahead as an inviting path for future generations provided the current economic traffic does not become snarled. It is important to have as high a rate of growth as the economy is able to maintain, but there is no rate that the Federal Reserve is attempting to impose on the economy, nor could Federal Reserve policies by themselves assure the attainment of a fixed rate of growth.

A periodic slowing down in industrial activity is to be expected. The objectives of monetary and fiscal policies include minimizing the ups and downs that have characterized our free enterprise economy. A level highway is preferable to one with steep hills and sharp dips. Reasonable success in the pursuit of this objective contributes to the longer-run goals of orderly economic growth and stable prices. In the past, the economy has tended to grow in spurts. It has responded rapidly to new technology and new resources and then paused to catch its breath. Or, it has used credit excessively, and then experienced a breakdown of the credit structure. This stop-and-go process has proved costly in many ways--unemployment, lost incomes, and the indiscriminate injustices of inflation. Consequently, the Federal Reserve seeks to eliminate those imbalances that are caused by excesses or stringencies in the use of money and credit.

Stable economic growth with full employment is essentially a process of maintaining an appropriate balance between productive capacity and consumption. If consumption is to expand when production is at or near capacity, then productive facilities must be increased first. Unless capacity is increased, additional credit will result in raising prices. But when the economy is already operating at full capacity, productive facilities can be expanded only if resources are diverted from the production of goods for consumption; neither investment nor consumption can be expanded further simply by inflating the flow of money with additional bank credit. Until recently, for example, the real limit on the amount of new housing that might be built in any year depended not so much on the need for better homes, or the market demand, or even the availability of financing, but on the supply of men and materials that could be drawn into residential construction. With all the other demands for labor and building materials impinging on the market, easier financing facilities could only result, and in fact did result, in increasing building costs.

By mid-1955, output of steel, aluminum, cement, paper and various other major materials except textiles, was already at or close to the limits of capacity. Rising outlays for industrial and commercial construction and for machinery created demands for these basic materials which, regardless of the available supply of money, could be satisfied only if other demands subsided--demands for automobiles and new housing, for example. The maintenance of equilibrium required the balancing of an intricate structure of consumption and investment involving a great multitude of goods and services. No master mind can direct with assurance the smooth functioning of this complex mechanism. Market forces and the price system must be relied upon to direct and attract the flows of money and of goods and of services into appropriate channels and to keep them moving. There are bound to be obstructions and hindrances and slowdowns from time to time.

As I mentioned earlier, the Federal Reserve is concerned primarily with total production and total incomes, and only indirectly with component parts. Orderly growth for the economy as a whole does not and cannot mean uniform rates of growth for all industries simultaneously. Improved living standards grow out of new technology and resources that generate new demands and shift production away from older industries. Among individual industries, there is a continual process of birth, growth, and decline. From this evolution emerges growth in total output, in productivity, and in the standard of living. Such changes in industrial structure should be facilitated rather than obstructed so that production can grow fastest in the areas where demand is greatest. Mobility of resources is essential to a healthy economy, and to orderly economic growth.

Excess capacity and limited gain in the demand for the products of the textile industry are not inconsistent with this portrayal of the economy as one in which demands for many other materials and for manpower resources have been restricted by supply. The supply of your major material--raw cotton--has been so large that the Federal farm price support level has generally been the market price level over the past four years. The capacity to produce man-made fibers had expanded so rapidly in the early postwar years that by the beginning of 1953 the poundage was about 170 per cent of the 1947-49 average. By that time capacity began to overreach requirements. Although capacity for some of the newer fibers has continued to grow, productive capacity for rayon and acetate has exceeded demand.

Cotton spinning capacity has also been excessive, despite the gradual reduction over the years in the number of spindles that has tended to bring capacity closer to rising needs. As your industry well knows, there have been some pronounced cycles of rise and contraction in spinning activity during the postwar period. Fortunately, they have been less severe in amplitude and have had less impact on income and employment than some of the prewar fluctuations when the general economy was less prosperous.

As I mentioned earlier, the nation's defense purchases and its plant and equipment outlays have centered demands largely on metals and metal products. Gains in the demands for textile products have been less rapid. In fact, the increase in the total annual output of cotton and synthetic fabrics has paralleled the growth in population. As you know, the per capita consumption of all textile fibers rose sharply during the Second World War. In the early postwar years, it was bolstered by inventory replenishment and temporarily large exports. Last year's per capita consumption, however, was reduced. Excepting two years, it was lower than it had been since 1940, but still was 25 per cent better than in the 1920's. Since that time, the per capita use of synthetics had grown, cotton had about held its own, and wool had declined. As the incomes of more and more people rise above subsistence levels, consumer demands for housing, autos, and appliances are stimulated much more than those for the necessities of life, such as food and clothing. Demands for the latter are not likely to grow much faster than population.

While the combined output of cotton and synthetic fabrics has expanded somewhat over the postwar years, the number of man-hours worked in the industry has steadily declined. As Mr. Murray Altmann of the Board's staff has observed, this suggests a substantial increase in output per man-hour--perhaps as much as one-third since 1947. In factories producing textile fabrics, average hourly earnings have increased about as fast as output per man-hour, and the wholesale prices of their products averaged substantially less last year than in 1947.

These facts, with which you are doubtless familiar, point to the high stake of textile manufacturers in the goals of fiscal and monetary policy. This is true even though your industry has not been experiencing demands so heavy as to press against capacity and to push your selling prices upward. In other key industries, excessive demands pressing against capacity have been reflected in general wage and price advances which affect textile industries adversely. They have brought about the higher wages that textile mills must meet, and the higher costs of new machinery, repair parts, fuels, transportation and other services. The relative position of the textile industry is likely to be worsened by inflation. Moreover, the reaction that inevitably follows an unrestrained boom is at least as painful for it as for others.

Assuming the stake in the objectives of fiscal and monetary policy of all industries and of all population groups, what are the prospects for economic growth and stability? As already indicated, stable growth in the economy as a whole is consistent with considerable instability in individual types of demand. A decline in government spending can be offset by a rise in private demand; an expansion in business investment spending can be offset by a decline in residential construction; higher investment in steel can be offset by lower investment in auto manufacturing. This is the phenomenon of the past half decade that has been described as rolling adjustment. It means that different types of demand take turns acting as the driving force in the economy, and that total demand is more or less equal to total capacity.

There are actually two types of influence at work here. On the one hand, there is the competition among businesses and consumers, as well as governments,--national, state and local,--for shares of the total credit and goods available in the economy. To the extent that demand slackens in one of these sectors, there can be an increased flow to other sectors. This is the rolling sustained growth that we have been observing.

On the other hand, there is a mutual interdependence of demands: high consumer demand generates high business investment demand, and business investment generates income to stimulate added consumer demand. And, more to the point, a drop in investment demand, whether from an excess of investment relative to consumption in some important area or from the lack of adequate financing, can tend to drag down consumer demand by reducing incomes. This is the cumulative response to movements in individual industries that gives rise to booms and depressions.

With the chance for such cumulative responses ever present, what may sustain the continuous rolling adjustments at high levels in the future? There are several possibilities. One of these consists of time lags in cumulative reactions. Take the extraordinary consumer spending of 1955 that helped to produce the 1956 rise in capital investment. If this investment boom was a response to the preceding boom in consumer spending, it was delayed until after the latter had tapered off. Unfortunately the delay was not sufficient to avoid shrinkage in the dollar's purchasing power. This 1956 business investment may, in turn, have surged ahead at an unsustainable rate and now be susceptible to some slackening while consumption continues to expand.

A second stabilizing influence consists of demands that may be partially deferred or postponed, and therefore act as a reserve for slack times. These have marginal status in tight credit markets, but stand ready to absorb funds when credit eases. Recent residential construction is an example of this type of demand, partly because of the relatively fixed yields available on mortgage credit, and partly because of the sensitivity of home buyers to mortgage terms. State and local government construction is also in this category, because of its relatively high sensitivity to the cost of borrowing. Some long-time business commitments, such as those for utility expansion, may also be influenced by interest costs. In the tight credit markets of 1956 some of these weaker demands for funds were squeezed by the strong ones originating in business plant expansion. Tight money markets attracted additional funds, but these were not sufficient to meet the total demand. As a result, most of the growth in total output in 1956 flowed into business investment, which expanded at a rate that cannot be expected to persist indefinitely.

In this situation, the deferred housing and school needs, important and desirable as these needs are, stand as latent supports for the economy until such time as business investment slackens. When that time comes, it may be of critical importance that such latent demands be available. Still other developments, such as the Federal highway program or another boom in expenditures for consumer durables, may support the economy. All of these demands contribute to the reserves essential for maintaining stable growth. In brief, then, the Federal Reserve objective is to help maintain stable levels of total demand in the face of continuing fluctuations in its different segments. The total demand target is determined by the capacity of the economy and moves along a growth trend line established by the economy itself.

That we must rely on rolling adjustments among the segments of the economy to produce stability out of instability creates problems of its own. Mr. Stephen Taylor of the Board's staff has observed that although some instability within the demand structure is inevitable, the uneven competitive strength of different segments makes the variation in the total wider than may be necessary. Moreover, the turns of the wheel expose us to risks of cumulative reactions degenerating into recessions.

The solution is not to be found in supplying sufficient bank credit to meet all credit demands, both strong and weak. That route leads to outright inflation with all its hardships and indiscriminate evils. Rather the answer is to be found in making free markets work. A large step toward this end is to remove institutional rigidities, such as legal limitations on interest rates payable on mortgages and school bonds that bar those desiring to build schools or homes from competing for the necessary funds.

The alternative to free markets is to resort to government subsidies, guarantees and tax benefits. These may shelter preferred groups and meet apparent social needs, but we must not forget that each time we use them we subtract from the credit, materials, and labor available to others who must rely upon the free market. The greater the amount of special shelter provided by government, the more difficult becomes the situation of those not so protected. In a free society, it is axiomatic that not everyone can be sheltered. It is understandable, therefore, that free markets should be looked upon as the central feature of our private enterprise system. If free markets are combined with sound monetary and fiscal policies, the long-term social gains from the economy depend upon the quality of decision-making by business and labor officials and by consumers.