For Release on Delivery
Approximately 2:30 p.m. EDT,
May 8, 1957.

STEADY JOBS AND STABLE DOLLARS

Address of C. Canby Balderston,

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

at the annual meeting of

The Health Insurance Association of America,

Washington, D. C.,

on Wednesday, May 8, 1957.

STEADY JOBS AND STABLE DOLLARS

The well-being of all its citizens should be our nation's primary goal. This means that social values should head any list of long-run economic or political objectives. But they can be achieved only if the dollar is kept sound. There is no conflict between the satisfaction of human needs for the people as a whole and the protection of the buying power of the dollar. With mass prosperity and mass savings, human welfare requires a dollar that is kept sound, both as a medium of exchange and as a store of value.

With 100 million holders of life insurance policies, 15 million savings and loan shareholders, 14 million employees with pension rights under private plans, and 66 million who are covered by social security, one would think that there would be severe competition to champion the rights of savers and those who depend upon them. It is encouraging that the Life Insurance Institute is currently using nation-wide advertising to create more public understanding and thereby lessen the danger of dollar destruction by imprudence.

Insurance plays an important role in today's economy as a repository of people's savings and as a bulwark against the economic insecurity that accompanies setbacks in health, old age or the death of the family's breadwinner. It has, therefore, seemed particularly appropriate to raise some questions about people and their dollars with you because of the peculiar responsibility the insurance industry bears toward both of them.

It might seem presumptuous of me to speak to you about the erosion of savings, the economic distress visited on those with fixed incomes, pensions, annuities, social security, and health and life insurance in times of inflation. But there are some misconceptions about the problem of inflation that I feel are important to discuss with you even though you do not share them.

In the first place, let me emphasize that the problem of inflation is a real one. We are in a period of rising prices and this has been the situation for some time. It is true that the rise has not been uniform in amount or timing for all kinds of prices, but when all prices are taken into account, the general price level has been rising for over a year. In fact, roughly one-half of the rise in the gross national product (the value of all goods and services produced in our economy) last year was absorbed by price increases.

Therefore, the importance and relevance of people's thoughts on inflation, especially if their thinking has included the misconceptions I have in mind, cannot be denied. The primary fact I wish to stress is the close connection between steady jobs and stable dollars. If we could get this across, many of the dangerous misconceptions about inflation would disappear.

It is a traditional view that debtors are benefited by inflation and that sound or hard money is detrimental to their best interests. Debtors are led to believe that a little more money, in whatever form, be it fiat money in France or Civil War greenbacks here, would enable them to pay off their debt obligations more readily and have more money "to spend". And in fact this is the case. What is not made clear by the Mirabeaus and Bryans is that the disadvantages of the process far outweigh the advantages to those very people who unthinkingly join the clamor to give them more money. Indeed, everyone, whether debtor, creditor, worker, or employer--large or small--has such a stake in stability that any apparent gains arising from an immediate increase in money income are only illusory.

The fact is that inflation is disruptive of stability and orderly growth. A misconception that is part of our intellectual currency today is that a little inflation is a good thing. A little inflation, sometimes thought of as roughly 2 per cent a year, would double the price level every 35 years. However, even if we accept the inevitability of creeping inflation, and I certainly do not, it is not possible to have just a "little" inflation.

Once the community accepts the prospect of continued inflation and begins to make its business decisions in the light of that prospect, the infant ceases to creep. It learns to walk, run, and finally gallop even though the gallop may carry it over the brink of the precipice that everyone agrees must be avoided. An inconvenient but inescapable fact of modern economic life is that phenomenon commonly referred to as the "wage-price spiral". This operates to reinforce pressures on prices caused by increased demand from any cause, including that part of the economy in which wage rates are set by bargaining between strong unions and strong corporations. When demand is at a high level it is relatively easy to pass along to the general public, in the form of higher prices, cost increases like those arising from wage advances in excess of increases in productivity. The resulting gain in profits is then an occasion for further wage demands, followed by still another price rise.

A continued rise in inflationary pressures is not only harmful to those who directly feel the effects of a depreciating dollar, but the distortions produced in the economy will eventually lead to downturn in economic activity. Under creeping inflation, there will come a time when rising costs in distorted sectors of the economy can no longer be passed on to the consumer, when profits are severely reduced, and when production is cut back seriously, with widespread unemployment resulting.

Another form of the misconception that inflation is relatively harmless and even good is the belief that inflation is inevitable. This expectation of a slowly rising price level is based on two assumptions. Continued strong demand on the part of the government, business, and consumers will maintain the ease with which the wage-price spiral can continue to operate, and the improved ability of the government to avoid a real recession through government spending, built-in stabilizers, and improvements in the banking structure, will prevent any serious contraction. Moreover, the price level will continue to rise because the country is not prepared to accept either of the two known methods of control--sufficient credit restraint to create enough unemployment to halt the rise in labor cost or drastic government controls of wages and prices.

It is my own belief, however, that with general monetary control and sound fiscal policies orderly economic growth and reasonably stable prices are compatible. I decline to accept the doctrine that we can not have price stability without heavy unemployment. My principal argument is that excess capacity tends to depress prices and to curb price rises. As capacity catches up with demand, prices recede. Witness the record in cotton spinning, the production of rayon and acetate, and the weaving of cotton and synthetic fabrics. In the last of these, the data suggest that both productivity and wage rates have increased about one-third since 1947 while fabric prices have fallen.

My second observation is that the belief that creeping inflation is inevitable is both self-defeating and dangerous. It is self-defeating because it is the rational foundation for bargaining in wage negotiations for escalator clauses that tie wage rates to the cost of living and form the basis for the wage-price spiral. Hence, some company executives believe that if they are going to need more plant capacity they had better get it before construction costs rise further, thus bringing on the very malady they dread. It is dangerous because it has an insidious effect upon the quality of decision making by businessmen, who reason along these lines: "Suppose we do make a mistake and overbuild, the market for our product will eventually expand with population growth and by that time the rise in the values of buildings and equipment will validate our decisions." Subconsciously, perhaps, the feeling is that it is better to err on the side of overbuilding and thus keep up with the competitive Joneses for creeping inflation will tend to make miscalculations of capacity in relation to demand look like canny decisions.

Such an "inflation psychology" can encourage a full-scale inflation through its effects on people's spending, saving, and investment habits which could not help but be followed by a slump. Dr. Ralph A. Young of the Board's staff has explained the danger succinctly: "The widely held view that, to sustain high employment, creeping inflation is desirable, and in any case inevitable, invites also the expectation that further inflation is highly probable. Spread of this expectation could rapidly activate new spending and borrowing, further increasing the turnover of deposit money. Instead of a rolling adjustment in output and prices under more actively competitive conditions and in preparation for a new stage of advance without inflation, immediate resumption of inflationary tendencies would threaten."

It is my belief that we can have growth in demand, employment, and output and maintain at the same time the financial equilibrium of the economy. Indeed, without the maintenance of a stable dollar, such growth would be impossible. If we do not believe that inflation is necessary if growth is to occur, what can we do to prevent or control it? This brings me to the final misconception I want to discuss, that inflation can be stopped without inconvenience. This is the fallacy that most hampers any serious attempt on the part of responsible authorities to preserve the stability of the economy. To control inflation we must avoid spending more than we earn in production, which means cutting down demand. The problem is, therefore, how to select which demands are to be cut in the most impersonal and equitable way.

In the case of an inflation under wartime conditions, the unpalatable but effective action taken was to adopt rationing and to place direct controls on wages and prices. To the extent it was applied effectively, rationing did reduce effective demand for the time being, but it resulted in an accumulation of unspent funds in the hands of willing buyers that eventually burst through the dams of price and wage controls. While necessary in wartime, such direct intervention in individuals' freedom of choice to buy what they will and at whatever price is in contradiction to our belief in the desirability and efficiency of the free market choice and free private enterprise system. It is clear that such controls would not be effective in peacetime, since even when supported by wartime patriotism their success was limited and in the end they did not prevent inflation.

In view of their inadequacy as well as their unpopularity and doubtful efficiency, we can assume then that direct controls will not actually be used to combat a peacetime inflation. This leaves us with the tools of fiscal and monetary policy. Fiscal policy to combat an inflation involves (1) the use of the taxing power to curb excessive demand from the private sector, and (2) a reduction of spending in the public sector, until the government budget shows a real and sustained surplus. The role of monetary policy is to control the amount of money, through regulation of the reserves available to commercial banks, so that growth in the money supply will not put additional pressure on the demand for goods and services available. While both are important in stabilizing the economy, I would like to discuss more fully the role of monetary policy in combating inflation.

Monetary policy by restricting the supply of money and credit cuts down spending by increasing the price of money, the rate of interest. In effect, this substitutes an increase in the price of money for an increase in the price of goods. The allocation of the available supply of money and credit is then left to market forces, going to those borrowers who are willing to pay the higher price for borrowed money. This use of rising interest rates to exclude borrowers from the market is that which is most consistent with a free market system. The "tightness" of money over the past year has resulted not from actual restriction on the supply of money and credit in being but from increased demands of borrowers. If the supply of credit had been allowed to increase to satisfy all demands, it would only have added to inflationary pressures without adding to the supply of goods, and prices would have shown an even greater rise.

The price rise, coupled with the expectation of further inflation under a weak monetary policy, would activate borrowing and spending, as I indicated earlier, and would still further multiply credit demands. Sooner or later, lenders would become increasingly reluctant to lend, at least insisting on an interest premium to compensate for the purchasing power depreciation of the dollars lent. Thus, eventually in inflation, even interest rates get out of control, and rise because of inflation-generated demand and supply forces. It is a fallacy to think interest rates can be kept low by government fiat. The forces making interest rates are elemental, all-pervasive forces.

The way in which the available supply of money has been allocated among various sectors of the economy by rising interest rates has been sharply criticized. It has been said that this has deprived us of vitally needed schools, roads, and housing, and has unduly hurt small businesses. It has therefore been suggested that these preferred groups of desirable projects should be exempted from monetary restraint by government action.

While the desirability and importance of these activities are not to be questioned, it must be remembered that if these types of demand are to be given special shelter from market forces, some action must be taken to decrease other types of demand if we are to avoid inflation. It is certainly possible, and in some cases desirable, for the government to act to shelter certain groups, but it is a matter of simple arithmetic that all groups cannot be given special shelter. It follows, therefore, that the larger the number accorded special protection or help, through government subsidies, guarantees, loans, and grants, the more pressure will be exerted on the groups that use the free market.

This question of the differential impact of monetary restraints on certain groups of the population involves the larger question of whether the social needs of the community for jobs, schools, roads, and housing are in conflict with the maintenance of a sound dollar. My contention and belief is that there is no conflict. But no matter how great is our need and desire for more and better schools, roads, housing, and productive facilities, the simple fact is that they must be fitted into our available capacity and resources. We cannot have everything at once if our objectives are to be maximum growth and a stable price level.

In the final analysis, investment must be financed primarily by taxation or by real savings from current income. A small amount of investment may be financed out of bank credit expansion to provide for monetary growth, but this amount must be kept within the margin of tolerance for a stable dollar. The advantages of a stable dollar certainly outweigh the disadvantages of temporarily postponing additions to housing or plant and equipment that cannot be financed out of savings, or schools and roads that the community is unwilling to finance out of taxes.

Our economy has a great capacity for growth. Ours is an era of technological and social progress. In this climate, our monetary objectives must be twofold: to foster continuance of economic growth and to prevent either inflation or deflation. The attainment of these goals depends on the courage with which we pursue the good of the greater number rather than that of the few, on the wisdom of governmental officials to control excesses through wise use of the weapons at their disposal, and to no less degree, on the understanding and cooperation of our private citizens.