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PRUDENT DECISIONS AND SOUND MONEY

Address of C. Canby Balderston,

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

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PRUDENT DECISIONS AND SOUND MONEY

Just as the boom is world-wide, so are the tendencies to inflation. During the postwar period, economic activity, both here and abroad, has been marked by high utilization of human and material resources and strong inflationary pressures.

In early 1957, the industrial production of the free world was about 20 per cent higher than in 1954. In Western Europe gross fixed capital increased about 20 per cent in that period, and in the United States the output of business construction and producers' durable equipment increased 15 per cent.1/ The whole world has benefited from a stream of inventions and discoveries that has expanded into the technological advance which is an outstanding force of our generation. The upswing has been accompanied by some inflationary strain, and the prices of industrial commodities and of consumer goods have been rising. Consumer prices rose in the United Kingdom, Germany and the Netherlands during 1954; in the United States and Canada, starting in 1956. In the last two countries, the increase by the middle of this year had amounted to about 5 per cent, but for most Western European countries it ranged from 6 to almost 15 per cent.

Under the pressure of economic expansion, demands for loan funds have increased sharply, and in the absence of comparable increase in savings, have created a strong upward thrust of interest rates in the money and capital markets. In most countries the monetary authorities have sought to limit the amount of central bank credit available to the commercial banking system. In some, commercial bank loans have been placed under ceilings, and licenses have been required for new security issues. In the struggle

1/ See August 1957 Federal Reserve Bulletin: "Interest Rates in Leading Countries."

to contain inflation, rising interest rates have helped to curb the demand for credit and have encouraged saving. But throughout the world current interest rates are below the levels reached in the 1920's, and those in the United States are generally below those in other leading countries.

Current U. S. business trends

Until a few months ago the aggregate demands in the United States, both governmental and private, for scarce materials and labor pressed hard upon our resources, and prices rose as a result. Especially did the prices of metals and metal products rise. Now, many of these production bottlenecks have been removed, but savings and certain labor skills remain scarce in relation to demand. The desire to invest continues to exceed the rate of saving.

Economic indicators are reflecting continued inflationary pressures in some sectors and abatement in others. For example:

Personal income continues to establish records. In July and August, 1957, it averaged 6 per cent higher in dollars and 2 per cent higher in purchasing power than a year ago.

Consumer spending continues at a record rate, especially for non-durable goods and services.

The August consumer price index was 3.5 per cent above August, 1956.

Purchases by State and local governments, currently at a seasonally adjusted annual rate of $36 billion is increasing by almost $3 billion per year, or about 9 per cent.

Business expenditure for plant and equipment, however, has apparently leveled off though at a high level.

Exports are still high but may decline, partly as a result of financial readjustments abroad.

Since the end of May, business loans at the weekly reporting city member banks have increased $1.25 billion, about one-third less than last year. However, the volume of new loans made by these banks has continued to exceed last year's volume of new lending. But the volume of repayments has increased more rapidly than new lending.

Although business as a whole seems to be leveling out at the moment, it remains remarkably strong, and the potential for inflation most certainly still exists. When increases in GNP in current dollars are almost matched by increases in average prices, monetary authorities cannot be complacent about inflationary dangers.

Credit restraint

Under private enterprise, there is no precise mechanism for assuring an automatic adjustment of the money supply and its use for meeting the appropriate needs of business and fostering orderly economic growth. In the absence of quantitative checks upon the money supply, our economic system in times like these would tend to generate excessive amounts of money and credit and bring on inflation. Under certain circumstances, inflation can not be arrested without a painful aftermath.

Although it is true that, under our system, the government influences the total supply of money and credit, its allocation among borrowers is left to private institutions in the money and capital markets. The Federal Reserve has responsibility for the supply, availability and cost of credit,—a responsibility which it discharges primarily by influencing the reserves of commercial banks. Left unaffected by an agency such as the Federal Reserve, the total pool of credit would become excessive in boom times and lead to inflation through the supplying of excessive amounts of short-term credit. In brief, the aggregate demands of credit-worthy bank customers would result in a total that would be inflationary unless restrained.

This emphasis on the importance of bank credit does not imply any support of a simple monetary theory of business cycles. There is no suggestion that bank credit expansion and contraction alone cause booms or busts. The point is that whatever the cause of industrial expansion and rising business investment, the increased volume of business feeds on money: generally speaking, the larger the volume of money, the greater the dollar value of business permitted, even if overall capacity levels have been reached and the increase in the dollar value of business is chiefly a reflection of rising prices. If business growth is to be orderly, the Federal Reserve must not permit the creation of a credit pool that exceeds the requirements for sustainable economic growth. As Mr. Thorneycroft, British Chancellor of the Exchequer, told the American Bankers Association, ". . . It remains true that money, particularly new money, if it is not the cause, is certainly the necessary food of any inflation."

Other testimony from abroad indicates that those countries that were most successful in rising out of the disorder following World War II faced up to the problem of restraining inflation resulting from excessive quantities of money by curbing the volume of lending. This was done, for example, in the Federal Republic of Germany, the United Kingdom, and Italy. The techniques of restraint have varied from country to country, but all were designed to keep expansion of money and credit consistent with sustainable growth in productive activity.

Allocation of credit

The apportionment of the credit supply among individual borrowers, in contrast to the governmental influence over the total, is a matter for private lenders operating through free markets. The selection of the particular customer to whom loans are to be made is, and should be, left to the discretion of private institutions. Unless the allocation is left to the operation of free markets, it will be arbitrary and inequitable.

If the total supply of money is restrained with its allocation determined by private institutions and private money markets, criticisms must be expected from groups that feel restrained unduly. The way in which the available supply of money has been allocated among various sectors of the economy by rising interest rates and other market forces has been criticized sharply. It is argued that lack of availability has delayed the builders of schools, roads, and housing, and has affected small firms more adversely than large ones. It has been urged that their financing be sheltered from monetary restraint by government action.

In fact, the government has tended increasingly in recent years to modify the private allocation of resources, including money supplies, in an effort to meet various worthy objectives. There are government aids for a whole range of desirable projects, including a special agency to offer aid to small business.

While the social and economic importance of these borrowers is not to be questioned, it has often been true that programs of national defense, school and church construction, road building and additional housing may, during boom periods, accentuate the overall problem of achieving monetary stability and orderly growth. As Messrs. Koch and Arlt of the Board's staff have observed, the problem of any democracy is to blend a whole complex of objectives, including more schools, better roads, better housing, greater national security, full employment, orderly growth and sound money. At certain times, one objective may receive more emphasis than another. When it becomes necessary to adopt a policy of credit restraint in order to maintain relative stability, the attainment of some desirable objectives may have to be postponed. It is a matter of simple arithmetic that we cannot have everything at once.

One of the chief complaints raised against monetary restraint is that it discriminates against small business. Like the other charges relating to the differential impacts of "tight money" on schools, roads, and housing, that relating to small business is very difficult to appraise. The information now available on small business financing does not appear adequate to provide precise conclusions as to the impact of monetary policy on small firms. If impressions are to give way to understanding and to appropriate policy actions, the following questions require answers:

1. What is a small business? Can the same definition embrace varied lines of activity, such as small steel mills and small grocery stores?

It is possible that the criteria used in earlier investigations may no longer be applicable in view of the enlarged scale of current business and the higher price level. The type of retail business that could be started for as little as $1,500 in the 30's is likely to require $12,000 or more today.

2. What criteria does one use to determine the adequacy of financing facilities for small business? This question raises a host of others:

(a) If small business has a distinctive financial need, is it for short-term, intermediate-term, or long-term credit?

(b) To what degree is equity capital unavailable to small business? Is a scarcity, if any, the result of credit restraint, of taxes, or of some other influence?

(c) Even if small entrepreneurs need more equity financing, are they willing to raise more capital in this form?

(d) If those small firms with thin equity have to rely on borrowing of the more expensive types, is this difficulty aggravated by credit restraint?

3. To what extent does the credit standing of small business borrowers deteriorate with any slowing up in the rate of growth of economic activity?

We have some scattered evidence to indicate that small enterprises differ from large companies in that their sales and earnings fluctuate more sharply. Because of less diversification in their products, and more limited access to economies, they may be more vulnerable to changes in over-all business activity, shifts in demand, and regional changes.

4. If there is a problem of inadequate financing for business, does it focus essentially on small vs. large, or upon new vs. established firms?

5. Are the capital requirements of new businesses such that they cannot be met by the available sources of loanable funds?

6. What significance is to be attached to the figures on business failures? How are they related, if at all, to credit restraint?

7. How is the problem of small business financing related to that of management?

The above questions concerning the status of small business are but a few that might be explored. They suggest the importance of a thorough inquiry. Until more light is shed upon these and other questions, the impact of monetary policy on the small business sector of the economy cannot be appraised adequately.

The Federal Reserve System is undertaking just such a survey of small business financing problems. This investigation is likely to cover three broad topics:

A. A review and analysis of existing material and data on the financing of small business.

B. Studies of the lending operations and policies of the principal types of suppliers of funds to such firms.

C. A study of the financial structure and financing experience of small enterprise, based on data obtained directly from a sample of typical small businessmen.

A study of such scope, important as it is both to small businessmen and to American financial institutions, calls for concerted effort by the financial community, the Federal Reserve, and others. In particular, many of you will again be asked to provide information as to your business loans. We will need to solicit interviews with some of you as to your lending policies. We will also welcome your views as to any aspect of the undertaking.

The 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 fact, in conflict with the maintenance of a sound dollar. Fundamentally, there can be no conflict. No matter how great is our need and desire for more and better schools, roads, housing and other facilities, the simple fact is that they must be fitted into our available capacity and resources.

In boom times, 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, but this amount must be kept within the margin of tolerance for a stable dollar. The advantages of sound money certainly outweigh the disadvantages of temporarily postponing some additions to housing or to plant and equipment that cannot be financed out of savings, or to schools and roads that the community is unwilling to finance out of taxes. To protect the purchasing power of the dollar and to foster stable growth in the economy are of supreme importance to those dependent upon jobs as well as to those dependent upon savings. This means that the well-being of our children and the future strength of the nation call for prudent decisions by both lenders and borrowers, private and public.