

Some Factors Affecting Monetary and Credit Policy

Remarks by Mr. Chas. N. Shepardson, Member of Board of Governors, Federal Reserve System, at Pacific Northwest Conference on Banking, April 11, 1957, at State College of Washington, Pullman, Washington.

The Federal Reserve System has as its broad objectives the maintenance of price stability and the fostering of sustainable economic growth. It seeks to achieve these objectives through its influence on the cost and availability of credit in the market place. I propose to discuss with you today some of the ways in which this credit policy is related to achievement of these goals of price stability and economic growth.

In an expanding economy geared to the needs of a growing population such as ours, there is a continuing need for more jobs to provide the earning power for this growing population and for more production of goods and services to meet their demands. Such growth calls for a continuing investment in production facilities, both for expansion and for modernization or replacement. This means that, at any given time with full utilization of existing manpower and production resources, total output should equal demand for current consumption plus that needed for expansion. Or to state it conversely, consumption must be limited to that fraction of total production which will leave the requisite amount of manpower and materials to provide for needed replacement and growth of plant and equipment. By the same token, income from such production must be apportioned, part to current consumption expenditures and part to savings to finance the necessary capital expenditures for these production facilities.

In a free economy there is no way to insure an automatic balance between the flow of spending and the flow of goods and services. Decisions to spend are made by millions of individual businessmen, farmers, and workers, all of whom are also consumers. Access to bank credit and to cash balances previously saved makes it possible for business and consumers to spend in excess of their incomes. Usually, while some units in the economy are spending more than their incomes, others are spending less than their incomes -- that is, saving. As long as the total of spending in excess of income equals the total of saving, the economy will remain on an even keel, avoiding both inflation and deflation.

At times, however, the use of credit or the spending of cash balances tends to exceed saving. The result is that the demand for goods runs ahead of the amount produced and prices are forced up. The opposite tendency leads to a shortage of spending relative to the potential of the economy, and the result is falling prices and reduced output.

In a strictly free economy, we would depend on the forces of the market to equalize these supply and demand pressures through the price mechanism, including interest rates on money. However, since market adjustments are subject to violent and sometimes erratic fluctuations, we have assigned to fiscal and monetary authorities the task of moderating the gyrations of the money market through their power to influence the cost and availability of money and credit. Both of these forces act on the stream of spending and affect its size in relation to the stream of goods the economy is capable of producing.

The government budget is itself a major component of the flow of expenditures and, in addition, influences private decisions to spend for consumption and investment. Government taxation affects the spendable income of business and consumers. Debt management policies also have an important influence on credit markets and on the terms and availability of funds to private borrowers. While fiscal policy thus plays a vital role in economic stabilization, government spending and tax programs are not adapted to quick alteration in accordance with short-run variations in economic conditions. That is the special province of monetary policy.

In performing its task, monetary policy is usually concerned with slowing or hastening rates of growth of money and credit rather than with contracting the money supply. Monetary policy normally utilizes either the brake or the accelerator; seldom does it find it necessary to put the gear shift into reverse.

Thus, despite the public discussion of "tight" money and credit scarcity, bank credit expanded by more than \$4 billion or about 2-1/2 per cent in 1956. That growth, however, was less than the growth in the demand for credit. In that relative sense, credit was scarce.

In a period when resources were intensively utilized, further growth of credit would have resulted in greater increases in prices since in terms of physical resources there was little margin for growth of output over and above what was achieved in 1956.

During the past two-year period of upward pressure on prices and of credit restraint, we have heard much talk about "creeping inflation." It has been argued by some that creeping inflation -- by which is meant a steady

but gradual upward movement of prices of 2 or 3 per cent per year -- is probably inevitable if the United States is to continue to maintain economic growth with full use of resources.

Those who tell us that creeping inflation is inevitable, and that we ought to relax and enjoy it, base their case on the proposition that the collective bargaining process is bound to raise the wage level more rapidly than the growth of labor productivity. They contend that, although the resulting increase in unit labor costs must eventually reflect itself in a rising level of prices, this rise can be kept within reasonable limits.

It is not my purpose to attempt to predict the course of collective bargaining over future years. I cannot refrain from observing, however, that the creeping inflation argument appears to attribute a certain amount of short-sightedness to labor leaders. We are asked to believe that these leaders would be so blind to rising prices and a rising cost of living as to confine their demands for wage increases to amounts only slightly in excess of the rise in productivity.

We may be sure that labor leaders are not as short-sighted as they are made to appear by this argument and that if prices were allowed to creep upward wage demands would inevitably reflect the anticipated rise in the cost of living. In fact, the built-in cost of living and productivity increase clauses in many of the present wage agreements provide concrete evidence of this line of thinking already. Similarly, businessmen, farmers and consumers would begin to take account of expected increases in prices and costs. Goods would be bought and held for speculative purposes. Prices would be established not on the basis of actual costs but on the basis of anticipated costs.

This would not only distort the pattern of production and investment but would, along with other undesirable effects, provide a further impulse to inflationary pressures. In consequence, wage demands would be further increased. In other words, it is likely that inflation would stop creeping and would begin to run.

While no one wants a run-away inflation, there is an even greater fear of deflation. Although the entire history of our country is a record of continuing growth and expansion with only temporary interruptions, we still seem to have an overwhelming fear of depression. It is this fear of getting too close to the line of equilibrium that drives many people to accept the idea of a little inflation even though inflationary excesses again and again have brought on us the wreckage of depression. And the exhilaration of a little inflation inevitably leads to these excesses.

In fact, our present day mania for speed seems to have infiltrated our economic thinking. Our pathway of economic progress is like the mountain roads with which you are all familiar. It is a series of hills and curves with limited visibility ahead. Certainly, it is bad business to go so slowly that we stall our motor on every hill, yet there are far more crashes and fatalities from rounding a curve or cresting a hill too fast than there are from stalls. Just so, the danger of a depression is far greater from excessive acceleration than it is from a careful deceleration even though such deceleration may bring an occasional stall.

I would conclude, therefore, that creeping inflation is not a realistic alternative to price stability as an objective of economic policy. Furthermore, I would reject the premise that creeping inflation is necessary if we

are to enjoy economic growth. In fact, inflation might well discourage economic expansion.

Another of the principal reasons for rejecting the acceptability of creeping inflation lies in the relationship of price stability to savings and of savings to economic growth. Within the institutional framework of our economy, a large portion of savings is in the form of fixed dollar obligations, such as bonds, claims on pension funds, insurance policies, and deposits. If a steady rise in prices came to be generally anticipated, the incentive to save would inevitably be weakened. This in turn would lower the rate of capital formation, with the result that economic growth in real terms would slow down.

One of the consequences of our economic progress is that an increasing proportion of the population is accumulating pension and retirement benefits. The rapid growth of pension funds among financial institutions is evidence of this fact. The result is that an increasing proportion of the population has acquired a direct stake in stable prices. Creeping inflation would cause pensions and other such claims to lose their value, exacting severe costs in terms of human misery.

In this connection, an important part of the growth of pension funds has been stimulated by collective bargaining demands for pension rights as a supplement to Social Security benefits. This is another factor to be considered in connection with arguments for creeping inflation. It means that labor unions also have a stake in price stability. It also means that, should creeping inflation come to be accepted as permanent, demands for upward adjustments in pensions would also be frequent. This would add further fuel to the fires

of spiraling prices and make it even more difficult to prevent creeping inflation from degenerating into a gallop.

Price stability by itself cannot insure economic growth. If, however, we are able to preserve financial stability the prospects for sustained economic growth in this country appear, from all indications, to be very promising. For one thing, prospective population trends foretell strong consumer demands. Rising population does not automatically bring with it a growing standard of living, as experience in many countries demonstrates. In our own economic system, however, rising population tends to call forth both higher demands and increased productive capacity.

Apart from the upsurge of population, technological factors also contribute to the favorable outlook for economic growth. The terms atomic energy and automation immediately invoke a picture of vast technological development. Here in the West one might speak of the technological frontier that has replaced the land frontier. The land frontier, inviting economic development, was an important factor in economic growth in the United States as a whole. In many respects the new fields of technology that modern science has opened to us constitute an even broader frontier inviting economic development. The incentives to push back and exploit this frontier are felt by consumers, farmers, and businessmen. In the case of consumers, there is the promise of greater leisure and of attractive products that increase comfort, reduce effort, and provide pleasure. Producers find it possible to introduce new products, reduce costs, improve quality and, in the process, to increase productive capacity. As in the case of the land frontier, the technological frontier encourages the growth of demands for goods and services and also of the productive facilities to satisfy these demands.

One might press the analogy further and say that many of the qualities that we associate with the pioneers who pushed the frontier westward are also involved in the technological upsurge we are now experiencing. The imagination, ingenuity, and willingness to accept change that characterized the frontier are also playing an important role in the rapid economic progress the United States has enjoyed in the twentieth century. In this connection, it is significant that, in their effort to stimulate more rapid economic growth, some of the countries of Western Europe are attempting through productivity programs to instill some of these qualities into industries that have become ossified and fearful of change and competition.

The upsurge of population and the prospects for technological advance, while providing the basis for optimism regarding the strength of demands for goods and services, also have implications for the amount of capital goods our economy will require if these demands are to be satisfied. With rapid population growth we must expect, in due time, a corresponding increase in the labor force. To provide jobs and homes for a rapidly growing labor force, we need large amounts of capital and this, in turn, requires saving.

If this needed capital is not provided through voluntary savings and if demands for goods and services continue strong, it would doubtless be provided through inflationary credit expansion were it not for the restraining influence of monetary and credit policy. But, in addition to the many other reasons for opposing this method of providing savings, there is the overriding argument that it is a self-defeating method. Persistently rising prices will in themselves discourage savings, at any given income level, and will thus give rise to still further increases in prices.

Hence, preservation of price stability is extremely important if the American people are to have the incentive to save the amounts that will be needed to provide the capital for economic growth. Unless people have confidence that the future value of the dollar will be stable, they will have little incentive to save. In addition, it is necessary of course that savers receive a reasonable return.

In thinking about economic growth, it is useful to remember that the westward movement of the land frontier was not a steady process. Rather, it occurred in surges as do most processes of development. Similarly, it is not certain that economic growth will be a steady upward movement without interruption either in direction or in rate of expansion.

Growth of our economy as a whole is the resultant of what happens in a multitude of different industries. We should not expect the output of all goods and services to grow together and at a constant rate. It is in the very nature of a progressing economy that newer industries will be advancing rapidly while some older industries may even be declining. For example, the output of television sets amounted to only a few thousand in 1946 but rose to 7-1/2 million in the next four years. This represents an enormous rate of growth and one which, needless to say, could not be maintained. In contrast, the production of anthracite coal was declining over the same period as other fuels replaced it.

Apart from the growth and decline of industries in response to technological developments, we have no reason to expect that consumer, business, and government demands will each expand at a steady rate without swings and cycles. Automobiles may attract a greater proportion of the consumer's dollar one year and clothing or houses another year. In response to such changes in

demand, there are bound to be changes in the rate of growth of different types of output, and this may in turn lead to variations in the rate of aggregate output.

It would be ideal, of course, if the type of rolling adjustment we have experienced in the past two years could be relied upon to prevent variations in output in individual sectors of the economy from being reflected in aggregate incomes and economic activity. In 1955 consumer outlays for homes and automobiles provided the principal expansive force in the economy. While these outlays declined in 1956, business plant and equipment expenditures surged ahead and overall economic activity continued to expand.

What is the role of monetary policy in this process of economic growth? One important function is the preservation of an environment of price stability and general financial stability. In such an environment people are more willing to save and to undertake the types of long-term investment commitments that are necessary if the technological frontier is to be exploited wisely. Economic growth requires capital investment and this in turn depends upon willingness to save.

A second general function of monetary policy in the process of economic growth is to attempt to smooth out the growth process. This does not mean that it is the function of monetary policy to attempt to regulate the rate of growth of each segment of the economy. As noted earlier, it is in the nature of a dynamic economy that there are fluctuations, some of a short-run nature and some of a longer-run character, in the output of individual industries.

At times when growth appears more rapid than can be sustained, a moderation of the rate of growth by means of a restrictive monetary policy tends to spread out over time the rising demands for goods and services and to avoid a later downturn. In other words, rolling adjustments are more likely to occur, along the upward path of economic growth, if some demands are postponed when total demands are already strong. If such postponed demands appear on markets at a later time, encouraged by easier credit conditions as earlier demands slacken, overall growth will continue.

It is with these objectives in mind that Federal Reserve policy has been directed toward retarding the rate of credit expansion in the face of the inflationary pressures of the past two years. There is some evidence in the current picture that demand pressure is lessening in certain areas. If and when aggregate pressures ease, we may reasonably expect some easing of credit conditions. On the other hand, a return to the excessive ebullience of a year ago might necessitate further credit restraint if we are even to approximate the price stability which is so essential to our continuing economic growth.

And now just a word about farm credit. Agriculture as a whole in this country is an excellent example of the effect of over-expansion of productive facilities. Unlike the situation in the farm depression of the thirties, the present depressed condition of agriculture is not due to lack of consumer buying power. It is primarily due to surplus production and can only be improved as we retire some of our less productive lands from cultivation and bring production more nearly into balance with consumption.

At the same time, agriculture is going through a technological revolution that is resulting in a tremendous growth in credit requirements for investment and operating capital. No longer can credit extension be based solely on character and collateral. Both borrower and lender must be able to make realistic projections of the earning potential of an operation and to adjust the amount and terms of credit extended to that earning capacity based on long-time averages of production. Some of the distress in the drought areas at the present time is due more to the extension of too much credit than it is to any lack of credit. This means that bankers and other lenders must find ways to adapt their lending practices to these changing needs if they are to continue to serve the farmers of their community.