FEDERAL RESERVE POLICY IN TODAY'S ECONOMY

Remarks by Chas. N. Shepardson, Member, Board of Governors, Federal Reserve System, at meeting of American Agricultural Editors' Association, Woodner Hotel, Washington, D. C. on September 26, 1957.

The job of the Federal Reserve System is to influence the behavior of bank credit and money in such a way that they will make the maximum contribution to continued prosperity and economic growth without inflation.

If we were to sit down together and draw up a list of requirements that we want the national economy to fulfill, there are a good many things on which we could readily agree. We want our resources to be fully utilized, with an abundance of economic opportunities for all types of people. We want output per person to grow as rapidly as practicable through increases in productivity, thus providing us the means to a fuller and more comfortable life. We want prices to be stable for some important reasons that I will develop in a few moments. We want to continue to have freedom of choice in our decisions about working, spending, and investing.

If we are to have these things we must preserve the condition that we call "economic stability." And we must accomplish this objective through financial measures -- primarily fiscal policy and monetary policy -- for this approach is the only one that will maximize our economic freedoms.

The threats to continued economic stability frequently are complex. Sometimes we may appear to be threatened from more than one threat and it is difficult to know which one represents the greatest danger to the maintenance of sound economic conditions. Analyzing the threats to economic stability and taking action against them is far from being an exact science. Nevertheless, it is a job that has to be done and, if we are not to suffer serious consequences, it has to be done well. We in the Federal Reserve System have responsibility for part of this job.

There are limits to the amount of influence that the Federal Reserve System can have on the economy and to the things that it can accomplish. If there is not enough demand for cotton and too much demand for steel, there is nothing that monetary policy can do about it directly. It can, however, help to preserve over-all economic stability by maintaining an economic climate within which such maladjustments can correct themselves most easily. Further, monetary policy is only one of several important phases of financial policy of the Federal Government that have an effect upon the over-all condition of the economy. The Government's program of taxing and spending and of managing the public debt is extremely important. Other types of Government action are also important. Examples are the housing and mortgage programs, Federal lending programs, and the farm programs. These programs contribute most to economic stability when they are all pulling in the same direction and the whole burden of constructive action is not placed upon one or two of them.

The main threat to continued economic stability with which Government policy has been grappling during the past two years has been that of inflation. This problem has reflected the fact that the amount which the total economy has wanted to spend for new investment has tended to exceed the economy's savings. This inflationary threat, like most economic problems, is not a simple matter but it can be illustrated by a few simple figures. It is reflected in the fact that average wholesale prices are 3 per cent higher than a year ago and 6-1/2 per cent higher than two years ago. Average consumer prices are up 3-1/2 per cent from a year ago. Other aspects of the situation include relatively full employment, amounting to 96 per cent of the labor force; a more rapid rise in industrial wage rates than in industrial productivity (e.g., in an increase of 5 per cent in straight time hourly earnings of industrial workers in the past year compared with 3-1/2 per cent increase in industrial output per manhour); and the relatively tight supply situations in some specific areas.

There has been some disagreement as to just what has been the cause of the inflation. Some have been disposed to argue that inflations can be divided cleanly into two types -- demand-pull inflations and cost-push inflations. They have said that the current inflation is of the latter type -- that it is a cost-push inflation. It is argued that the policies which would be useful in demand-pull inflations are therefore inappropriate and that monetary policy is one of these. Therefore, some would conclude that the Federal Reserve System should draw a jurisdictional line and hand this inflation over to someone else to worry about -- to whom they do not say.

All inflationary spirals, once they get under way, have both demand-pull and cost-push aspects. A demand-pull inflation could not get very far before costs would start pushing up under rising prices. A cost-push inflation could get nowhere if the demand were not there to absorb goods and services at rising prices, as witness the situation with our surplus farm commodities.

Any marked inflationary development has other aspects also. It involves changes in expectations as people come to base their planning increasingly on the assumption of further increases in demands and in prices.

These changes involve shifts in the structure of production as bullish expectations are capitalized into heavy expenditures for investment.

Inflation is a particularly dangerous thing if it extends over a period of time. It becomes even more dangerous as people come to expect it to continue. For then they begin to try to arrange their affairs so as to protect themselves from the effects of inflation, or so as to profit from it. When this happens the protective or profit actions people take will themselves speed inflation. People will become unusually willing to go into debt with the idea of paying it back later in depreciated dollars. Individuals and businesses planning to do some building will decide to do it before they really have to, before building costs go up still further. People will want to invest their money in common stocks and in land, and the fact that their buying pushes up the prices will make people still more anxious to buy in order to profit from further price increases.

We have seen this game played out in the past; it would not be anything new and different. So far it has always come to a bad end and I am sure that it would again if we let it get out of hand.

Another aspect of the problem that needs to be given due weight is the effect that inflation can have on the fairness of our economy and on the confidence and trust that people have in it. Inflation of prices at the rate of 3 per cent a year would reduce the value of the dollar by nearly one-half in 20 years. Those who put their trust in pension systems, savings bonds, insurance or other debt to provide for their retirement years or for the needs of their wives and children would find themselves robbed by inflation of a substantial part of their savings. The effects of a continued development of this kind on our economic and social system would be incalculable. For this reason even one who imagines that he personally can protect himself against inflation must, as a citizen, oppose it because of the threat that it would be to our society. It will be an unfortunate day for this country when people get the idea that pension systems are a fraud against them and that it is not safe to save and lend to others. It will be a sad day not only for those who have been hurt but for all of us.

We must fight inflation not only because of its own evils but because of the others that it leads to. When inflation is checked, as it must be finally in one way or another, the sequel, if it has gone too far, is likely to be deflation and unemployment. This has been the lesson of past experience in this country and others. I have not seen any convincing arguments that we can now experience inflation without fearing this aftermath. The inflation problem is one that we must see as a whole if we are to take effective action against it.

Having talked at some length on the dangers of continued inflation, I should make clear that I do not regard our present situation as an extreme one calling for drastic and unusual measures. However, it seems to me that as long as inflation appears to be a threat to economic stability, we must use the tools at our disposal in a reasonable but firm manner to combat it and get the economy back on an even keel. This means not only that we should continue to have appropriate monetary actions but also that other policies of the Government should be designed to contribute to the anti-inflation program rather than to undermine it or create loopholes in it. If we try to shelter some groups in the economy from the effects of the current shortage of savings -- say, by making credit cheaply available to them from Government funds -- this simply means that it is harder to hold the line against inflation and, if we are to hold the line, that restrictions must impinge even more strongly upon the unsheltered group. This is true since the Government has only two sources of funds -- either increased taxation or the method of kings of old, namely, clipping the coin; in other words, printing press money or inflation.

I have been talking in rather general terms about the place of Federal Reserve policy in our over-all effort to preserve economic stability. Federal Reserve policy works through influencing the ability of member banks to lend and thus create bank deposits, which make up most of the money used in this country. The Federal Reserve System can affect the ability of banks to lend because banks that are members of the System are required to keep reserves equal to a certain proportion of their deposits. These reserves consist of deposits with the Federal Reserve Banks. These are sometimes called "high-powered" money because one dollar of deposits at a Reserve Bank is enough to support more than five dollars in deposits at commercial banks.

Sometimes it is said that monetary policy has its influence through affecting the cost and availability of credit. However, we really should not stop with this. There are other important channels through which the effects of System action are felt. It influences the amount of money in the economy and this affects not only interest rates but also the liquidity of people and their willingness to spend or to enter into new commitments. Changes in the assurance with which people can count on getting new credit tend to have the same effect.

Some people appear to believe that the increases in interest rates since 1954 are entirely the nefarious handiwork of the Federal Reserve System or the Treasury. They appear to believe that if there were no intervention in the market the country could go along continuously with very low interest rates, and no ill effects from them. This idea, of course, is greatly mistaken. Basically, the recent increases in interest rates have reflected the great strength of demands for credit. For example, in the past two and one-half years outstanding home mortgage credit has increased $27-1/2 billion, consumer instalment credit $9 billion, and business credit $37 billion. This tremendous credit expansion has occurred in spite of very limited growth in money supply, largely through the increased velocity in use of funds and the high degree of liquidity in the economy at the beginning of this upsurge. It was inevitable that rates should rise as this excess liquidity was absorbed. Rising interest rates are characteristic of a period such as we have been having. They occurred under similar conditions before the Federal Reserve System ever existed. Rising interest rates during periods of rapid economic expansion are not artificial -- they are perfectly natural.

Also, rising interest rates have important functions to serve in such a period. They ration among prospective borrowers the limited supply of credit that the economy can use without inflationary consequences and they strengthen incentives for people to save and add to the economy's credit resources.

Basically, this increased productivity, which is essential to a continually rising standard of living, results from the substitution of capital for human labor. In a stable economy, capital or long-term credit for capital expansion can be acquired only as we withhold part of our production from current consumption and invest or lend it to another to invest in something that will return a greater satisfaction in the future. In other words, capital comes primarily from savings. Hence, we must have the assurance of the future value of our dollar and the incentive of a satisfactory return on the use of that dollar if we are to secure the amount of saving necessary to capitalize the continuing growth and increasing productivity of our economy. This is as true for the economy as a whole as it is for the farmer who knows that he must always hold back part of his crop for next year's seed if he expects to expand or even stay in business.

Of course, the Federal Reserve System could permit the commercial banks to create new credit by adding to the country's money supply. This would make more funds available for borrowing, and in an immediate sense this would tend to make for lower interest rates, but with the prospect of disaster in the end. First, it would not be a natural course but a direct attempt to keep interest rates artificially low by inflating the money supply at the ultimate cost of depreciating its value. Second, while its immediate effect might be to lower interest rates, its final effect would likely be quite different. If expansion of bank credit added importantly to inflationary pressures, it would encourage borrowing and discourage saving and thus result in interest rates higher than would have developed if inflation had been kept under control. We have witnessed this process at work in many countries where monetary expansion has been permitted to get out of control.

As you know, during the earlier days of our history farmers, harassed by large debts, and with little savings, sometimes were disposed to look to easy money and inflation as a solution to their problems. They felt that they had more to gain than to lose from inflation. I wonder whether farm people fully realize how completely their position in relation to inflation has changed. It seems to me that farmers now would be among the groups most immediately and directly hurt by inflation because it would affect the prices of the things that they buy more than the prices of the things they have to sell. Similarly, it would diminish the value of the large amount of liquid savings that they have accumulated.

There was a time when farmers were relatively little affected by increases in prices of nonfarm goods and services. They raised their own horses or mules and raised the feed for them; operating costs that had to be paid to others were not large. In terms of consumption also, the farmer raised most of his own food, built his own buildings, and rode to town behind his horse; his standard of living did not include a great deal that he had to buy from others.

Surely this is not the case now. Farm operating costs largely have to be paid out in cash, for expensive machinery and equipment, for gasoline, insecticides, fertilizers, animal feeds. And the farmer does not "live off the land" any more. He lives pretty much the same way as do city people and spends his money for the same sorts of things -- automobiles, store-bought clothing and furniture, vacations, education of children. When inflation develops, the farmer immediately feels the effects of it in the cost of the things that he has to buy.

However, inflation now would have very little effect on the prices of many of the things that the farmer has to sell. The demand for farm output is held down not by depressed general economic conditions and a deficiency of purchasing power but by physical limitations on the ability of people to consume foods and other farm products and declines in foreign purchases. Prices of many farm products will tend to be held down by the existence of accumulated surpluses, by the behavior of world market prices of farm products, and by the overhang of excess farm capacity now partially being kept out of production by government policies. For these reasons, prices of farm products would not be likely to lead an inflationary movement but would be laggards; the farmer would be likely to be caught between rising prices of the things he buys and relatively stable prices of the things he sells with a resulting tighter squeeze on net farm income.

The susceptibility of farmers in some earlier times to the lure of easy money also arose in part from their asset position. Often they were "land poor," owning large amounts of land and other physical assets, but heavily in debt. The desire to pay off their debt in depreciated dollars sometimes made inflationists of farmers. In this respect, also, the position of most farmers now is drastically changed, although undoubtedly there are some individuals who are still in the old position.

Farmers as a group are not now heavy debtors. Their total real estate debt at the beginning of 1957 amounted to only 9 per cent of the value of their real estate. The amount of fixed dollar assets that farmers owned actually was as large as their dollar liabilities. Depreciation of the value of their holdings of deposits and currency, savings bonds, and other debt would hurt farmers as much as depreciation in the value of their own debts might help them.

Thus, if any farmers still are influenced at all by the old idea that easy money and rising prices are the farmer's friend, even temporarily his friend, they should take a new look at the matter to see whether they are not fooling themselves.

As is evident from the figures I cited earlier, we have not been completely successful in our efforts to contain inflationary pressures. Since the very mild reversal in 1953-54, upward pressures in most segments of the economy have been very strong. In retrospect, it now appears that more prompt and somewhat firmer application of restrictive monetary policies in late '54 and early '55 would have been desirable. It also seems clear that more support from fiscal policy would have been helpful.

But perhaps we should not be too severe on this lack of perfection. I doubt that perfect price stability can ever be achieved in a free enterprise system -- or any other system for that matter. Furthermore, I am not at all sure that it would be desirable. Some upward drift in prices during periods when demands are pressing against our resources and some decline following these unusual periods of hyperactivity are not only unavoidable but perform a useful function in helping to bring about adjustment of spending and saving decisions in the economy. To my mind, the situation with the economy as a whole is not unlike that with an apple orchard. We need periods of active growth and fruiting and we need periods of relative dormancy. Without this seasonal fluctuation in growth we don't get any apples. Of course, we may have some wet seasons when the excessive growth of suckers would sap the life of the fruiting branches the next season if we didn't prune them out during the winter. In the same way, periods of slackened economic activity afford opportunity to prune out the inefficiencies and excesses which develop in any organization when it has more business than it can take care of properly. Only in this way is it able to move forward again with increased vigor.

While we have not succeeded in achieving the degree of price stability that is desirable, there are good prospects that we will be able to avert the spiraling effects of the expectation of further inflation. True, some observers still feel that creeping inflation is the order of the day. At the other extreme we have the prophets of doom who foresee the collapse of the whole price structure. But just as the farmer has learned to moderate the vagaries of nature with his fertilizers, insecticides, smudge pots, and irrigation, so are we learning to moderate the fluctuations in our economy through sound monetary policies. As evidence of the effectiveness of this policy and of our resolution to adhere to it accumulates, we find more and more confidence in the possibility that we can keep these economic fluctuations within tolerable limits while we continue to expand our productive potential. Personally, I think this confidence is justified provided we don't get chicken-hearted when the inevitable pruning season rolls around.