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MONETARY POLICY IN OUR ECONOMIC CLIMATE

Remarks by Chas. N. Shepardson, Member, Board of Governors, Federal Reserve System, at meeting of the National Agricultural Credit Conference, American Bankers Association, at Chicago, Illinois, on November 21, 1957.

I am very pleased to have this opportunity to speak with this group again. When I spoke with you two years ago, the economic climate was somewhat different.

<u>Two Years Ago</u>

At that time, inflationary pressures in the economy were very strong following rapid recovery from the mild reversal experienced in late 1953 and early 1954. Wholesale price averages had been rising since mid-year although farm prices were still tending downward. Consumer prices were not yet advancing but there were developing pressures in retail markets. Production had surpassed the 1953 peak although defense spending had been greatly reduced. Utilization of our industrial capacity and manpower resources was high and there were shortages of some materials. Demands for credit and capital were strong and expanding. Interest rates were rising as borrowing demands were outrunning the supply of savings being generated in the economy. Values of capital assets, such as farm and urban real estate and common stocks, were increasing along with costs of currently produced goods and services. In short, the economy was being subjected to strong and pervasive inflationary pressures.

In most other nations, too, expansion in activity was going on at a rapid pace, prices were rising, and demands for credit and capital were placing inflationary strains on their economies. Governments and monetary authorities were finding it increasingly important to strengthen their anti-inflationary monetary and other efforts in order to keep from losing gold and dollar reserves and to foster better internal balance among strongly competing demands.

In brief summary, this was the broad economic picture that confronted us two years ago. It was a situation that clearly called for vigorous action directed toward moderating expansive pressures in order to limit price advances and forestall development of a speculative psychology.

One of the basic purposes in striving for economic stability is to avoid the inequities created during inflation when those least able to protect themselves are hurt most. Another objective is to avoid the evils of deflation that will inevitably follow an unrestrained and long-continued inflation. These evils, too, bear hardest on those least able to protect themselves. Those of you close to agriculture know better than most the deflationary consequences of inflation. You may recall that after World War I the price of farm land was double its pre-war level. The price of that land dropped sharply during the 1920's and by 1933 it was substantially below its pre-War I level. You also know how difficult the task is of bringing supply and demand into balance. Costly government programs do not provide a simple solution. The situation can be greatly complicated and made far more resistant to correction if commitments during the preceding boom have become overly enthusiastic and have been supported by excessive credit.

We all want both our human and our material resources to be fully utilized. We want an abundance of economic opportunities, growing productivity and a rising standard of living for everyone. We want our freedom of choice to be as wide as possible in our purchases of consumer goods, in the investment of our savings, and in selection of our occupations. We also want full protection against any possible foreign aggression. These things cannot be obtained merely by wishing for them. It is necessary to work for them and to develop policies -- public and private -- which will contribute to an economic setting favorable to their achievement. Increased productivity, the only sound basis for a rising standard of living, involves increased capital investment. This, in turn, requires a proper balance between spending for current consumption and saving for capital expansion and that the sum of the two be kept within the limits of current resources. This is as true for the economy as a whole as it is for the farmer who must hold back part of this year's crop for next year's seed if he expects to stay in business and an even larger portion if he expects to trade it for an improved seed that will increase his future productivity.

The Employment Act of 1946, among other things, pledged the Government to use its powers to promote full employment opportunities and maximum production on a sustainable basis. The Act was passed at a time when the country was obsessed with fear of a return to the depressed conditions of the 1930's. The danger of inflation was not so clearly recognized at that time but the goal of economic stability is implicit in the pledge to assure sustained production. Maximum production and employment cannot be sustained if undermined either by speculative misdirection of resources and rising prices during periods of inflation or by frightened curtailments of activity and sharply falling prices during consequent deflations.

Clearly, economic stability is not, as has been argued in some quarters, an obstacle to growth and full employment. We are being told by some economists that creeping inflation is inevitable and necessary for rapid growth and full employment -- in other words, that economic stability must lead to unemployment and idle resources. Aside from the dubious morality of an economic policy that surreptitiously picks the pockets of some for the benefit of others, this argument would be more appealing if there were assurance that creeping inflation would not lead to galloping inflation. No such assurance can be given. Rising prices, if long continued, must certainly lead to expectations of further price advances. Such expectations, especially if they become widespread, encourage economic decision on that basis. People will naturally attempt to take advantage of, or protect themselves against, this "inevitable" trend. In so doing they will anticipate their future needs and compete currently against each other for goods and capital assets, thus driving up prices.

The process of speculative commitments, of investing ahead, for protection or future price gains will sooner or later influence lenders as well as borrowers to anticipate such increases and to make loans on a more liberal basis than otherwise. The acceptance by lenders of this philosophy will lead both to over-expansion of credit and also to misdirection of credit toward those profiting from price windfalls and away from those needing funds to finance production and growth.

When these optimistic expectations change as they must, the inflated volume of credit associated with these expectations will still remain. It must then be liquidated in a period when business expectations are of a different nature. Gains from price advances may become losses from price declines.

In such an inflationary situation as we had in 1955, the Federal Reserve System was faced with special responsibility of using its powers over reserves of member banks to help in safeguarding the value of the dollar and promoting sustainable growth in economic activity. In accordance with this responsibility, the System policy of credit ease, adopted earlier in order to foster rapid recovery from the 1953-54 recession, was changed to a policy of credit restraint. To curb the increasing use of stock market credit, the Federal Reserve Board raised margin requirements, first from 50 per cent to 60 per cent and later to the present 70 per cent. By limiting growth in bank reserves, thus curbing expansion in the money supply, the alarming rise in the rate of borrowing and spending could be retarded. But with continuing demand pressing on a limited supply of reserves, interest rates in all parts of the money market moved up. In the short-term area they rose to the highest levels in over two decades. In response to these developments, the Federal Reserve System advanced the discount rate four times during the year.

Continuing Inflationary Pressures

During 1956 and until recently in 1957, the primary economic problem in this country and abroad continued to be containment of growing inflationary forces. In this country, these forces were being reflected in credit markets and in markets for capital assets which might be assumed to provide a hedge against rising prices. The sharp further advance in the value of farm real estate over the past year may be a case in point, coming as it has on top of an already advanced level and in the face of a reduced level of farm income.

Inflationary pressures and expanding credit in 1955 were associated with rapidly expanding production, especially of consumer durable goods and new housing. Automobile production and sales reached an all-time high, aided by sharply eased terms on instalment contracts and a record increase in the volume of consumer instalment credit. Housing starts, although tending down during the year, amounted to 1.3 million units, not far from the record high in 1950. In 1956 and 1957, inflationary pressures and large credit demands were not resulting to the same extent in expanding output. The slower growth of total production reflected some shifting within the structure of demand with outlays for new plant and equipment rising very sharply to record levels in 1956, which were maintained in 1957. Consumers reduced purchases of automobiles and houses considerably but their expenditures for nondurable goods and services increased in 1956 and 1957. State and local expenditures also increased while defense outlays were generally above their reduced level in 1955.

The slower rate of growth in total output after 1955 reflected a closer approach to capacity limitations in some key industries, such as steel through 1956, and generally very high levels of activity and employment throughout the economy. Borrowing pressures were intensified and interest rates continued their rapid advance. Prices of commodities at wholesale rose further but at a somewhat slower pace. In retail markets, where there tends to be some lag, prices in early 1956 began a rise that persisted at least through September this year.

In this situation the Federal Reserve was faced with the necessity of exercising greater restraint on monetary expansion. Discount rates were raised twice in 1956 and once more in 1957. These advances were an essential part of a program to keep the Federal Reserve from feeding inflation. They also served as warnings to the public and to the banks that borrowing and spending were expanding too rapidly and that as a nation we were trying to go at a faster pace than we could maintain.

Recent Changes

Recently, economic and credit developments have become much more selective. The stock market has been subjected to a very sharp decline and this has been reflected in some weakening in business confidence in short-term prospects. With the stock market largely on a cash basis because of high margin requirements, however, the consequences of the decline have been limited. Calling of margin accounts, widespread forced selling and resulting pressures on credit markets, such as occurred in some other stock market contractions have not been of serious proportions.

Outside of the stock market, activity in many industries has continued expansive, but in many others adjustments have been increasingly on the downside. The rapid expansion of industrial capacity, especially in the past two years, has eliminated earlier shortages. Supplies of most materials and finished goods have become adequate, and, in some instances, excessive. Prices of some sensitive industrial materials, such as steel scrap, have declined sharply and the broad wholesale price averages have dipped slightly. The persistent rise in prices of consumer goods and services has tapered off. Although offerings in corporate security markets have been very large, demands for bank credit this autumn have not increased as seasonally anticipated. In the labor market, too, pressures have eased and the autumn rise in employment has been less than usual. Unemployment has continued relatively low although moderately above a year ago. Surveys of business intentions indicate lower outlays for new plant and equipment in 1958. Business inventory policies have become more cautious. New and unfilled orders have been declining. It seems clear that the boom has lost much of its momentum.

Signs of easing inflationary pressures have appeared in Canada and in many other countries as well as in the United States. It is too early to know whether the powerful upward thrust of worldwide inflationary forces has been blunted only temporarily or has been stopped. On other occasions in recent years, business sentiment has become pessimistic and signs of lessening inflationary pressure have appeared. On these occasions moderate relaxation of restraints was soon followed by resurgence of inflationary developments. It is hoped that this time the inflationary danger is actually over and that after a brief period of testing, such as we are now experiencing, growth will be resumed on a sound basis and at a pace that can be sustained.

Changing Policy Problems

In view of easing tensions in credit and goods markets in recent months, this has become a period when an alert and searching scrutiny of economic developments is especially important. We must be constantly aware of the numerous changes going on and be prepared to react to changes from either direction. We must be ready at all times to fight either inflation or deflation with equal vigor. As you know, Federal Reserve Bank discount rates have just been reduced from 3-1/2 to 3 per cent in response to these easing tendencies which have developed in financial markets and business activity.

At the same time, we must continue to be vigilant, reappraising the situation continuously as it develops. International developments are necessitating a re-evaluation of our defense and scientific research efforts. To meet this new challenge, more resources of various types may need to be brought into action. However, relaxation of credit restraint to meet our defense and growth needs must not be taken as a signal for a resurgence of a spending spree. In reviewing the 1953-54 experience, Chairman Martin has stated -- and I fully agree with him -- that the policy of active credit ease adopted to fight the mild recession of 1953-54 was carried out too vigorously, and that restraint during the recovery period may not have been reasserted as strongly or as promptly as now appears to have been desirable. As it turned out, there was at that time a large number of potential borrowers ready to enter the credit market when credit eased. The response to the policy of credit easing was so strong and insistent that we were soon confronted with rising prices and inflationary credit developments. In the light of this experience, we must be doubly alert to any sign of resurgence of inflationary pressures at this time.

In some ways, the inflationary problem of the past two years has been greater because the 1953-54 experience lent support to the view that the Government and the Federal Reserve could "manage" the economy and would not permit a recession to become serious. This overly-optimistic confidence in the wisdom and power of monetary and fiscal policy has become more widespread and has contributed to the view that it is "safe" to go ahead because the risk of loss from cyclical reactions has been greatly reduced. Moreover, some economists have gone further to proclaim the inevitability of continuing "creeping" inflation.

In such a climate of opinion, it would not be surprising if some businessmen, bankers, and consumers misjudged the situation and undertook investing, lending and purchasing commitments more freely than they would have otherwise. There can be no assurance that such overcommitments can be worked out without cost to those undertaking them or to the economy. There is no economic machinery by which markets at favorable prices can be assured for all products, whether or not they are wanted, or to all industries, whether or not they are efficient.

<u>Postwar Experience</u>

Actually throughout the postwar period, the economy has performed reasonably well and much better than most of us dared hope on the basis of our experience after World War I and in the decade before World War II.

During most of the period since World War II, the economy has enjoyed high employment and rising living standards, adjustments in particular lines being made all along. These rolling adjustments sometimes have been sharp in individual lines but, in a generally strong situation, have not lasted long. Declines in some activities have been offset by advances elsewhere so that changes in the total have been small. Consumer purchases of new cars and homes declined substantially last year while consumer expenditures for nondurable goods and services rose and business outlays for new plant and equipment increased very sharply. Nonmanufacturing employment continued to expand through August of this year while employment in manufacturing has drifted off to levels below a year earlier.

Policy Implications

This ability the economy has demonstrated to adjust flexibly to changes is heartening. The demonstration provides evidence of the underlying strength and resilience of our free enterprise economy operating under the guidance of general credit and fiscal policies. These policies have themselves been more readily adapted to changing conditions than might have been expected from examination of the historical record. The prompt relaxation of credit restraints and the development of a policy of active ease in 1953 and 1954 constitute a case in point. This experience suggests that flexible credit policy can have some contra-cyclical effects during periods of contraction as well as in periods of expansion. The structure and functioning of the economy have improved. Our instruments to deal with business cycles are better than before even though they are still far from perfect.

As is evident, we have not been completely successful in our efforts to contain inflationary pressures. 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 wholly 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.

One further fact in connection with monetary measures in our changing economic climate needs to be emphasized. Credit and monetary policy is not the only instrument available for combating inflation or for ameliorating deflationary trends. In order for such policy to be most effective, it is always desirable, and in certain situations imperative, that an appropriate fiscal policy be pursued. In an inflationary situation, a substantial Treasury surplus can be a powerful weapon. Conversely, during contractive periods, tax reductions or expansion in government activities serve in some degree to counteract declines in private demands.

In conclusion, I should like to add this basic thought which always should be kept in mind. In a free enterprise economy the achievement of economic stability requires more than appropriate government action. It requires that private individuals, be they consumers, workers, or employers, act with restraint in periods of inflationary trends and with calmness and faith in the future during periods of deflationary tendencies. Thus, while appropriate credit and monetary policies are indispensable to the maintenance of stability, we should not place sole reliance on them.

Maintaining stability and orderly growth in a free private enterprise economy requires a balanced combination of fiscal and monetary policy, together with intelligent self-discipline on the part of all citizens.

This self-discipline is of special significance at the present time. A patient with the flu is confined to his bed. When the fever subsides he may be released from bed but he is cautioned against too quick a resumption of activity lest he suffer a relapse that may be worse than the first attack. So it is with our economy, which has been suffering from a fever of inflation. Now, with the subsidence of the fever and easing of the pressure of restraint, we must discipline ourselves against the overexuberance which brought on the inflationary fever initially and the resumption of which might precipitate a dangerous relapse.