Rotary Club
Gadsden, Alabama
7-14-66

INTEREST RATES IN A FREE ECONOMY

Gadsden and Atlanta may seem close to an astronaut, but they are hardly neighbors. Yet they seem like neighbors to me, because I have been fortunate enough to have a good friend in Cooper Wadsworth, President of the American National Bank of Gadsden. Cooper and I have worked together on the Board of the Atlanta Federal Reserve Bank. Through my association with him, I have come to feel as though Gadsden were just a stone's throw from Atlanta.

We at the Atlanta Federal Reserve Bank must constantly assess the relative economic "health" of the territory encompassed by the Sixth Federal Reserve District. Our diagnosis is that Gadsden's economic "pulse" is strong and vigorous. Gadsden unemployment, estimated at 4.9 percent of the work force in May, is down from 5.5 percent a year earlier. Bank debits, a good measure of total spending, have been running 9 percent ahead since the first of the year. May demand deposits of banks in the Anniston-Gadsden area were 19 percent higher than in May 1965. Savings deposits were up nearly 15 percent.

Of course, these figures are probably old hat to you. And certainly no statistics are necessary for you to recognize Gadsden's substantial economic growth in recent years. In light of the persistence of this growth, you may even have allowed yourself the luxury of accepting rapid economic development as a matter of course.

Gadsden is certainly far from being alone in experiencing unusually rapid economic growth, which is typical throughout the nation. Cities from Maine to California have been enjoying phenomenal economic gains. As you know, the nation is now well into its sixth year of economic expansion, a record for any peacetime period in this country. Our output of goods and services, measured in dollars of constant purchasing power, is now one-third greater than it was

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

in 1960. Unemployment has been reduced from a rate of 6.7 percent in 1961 to around 4 percent today. Moreover, until 1965, this economic growth was achieved with relatively stable prices.

Since economic growth is not just a matter of luck, it is important to note how this tremendous growth occurred without drastic price increases and why we must prevent such increases. We were able to grow without a significant rise in the general price level because we put to work previously unused manpower and productive capacity. Also contributing to this noninflationary growth was a steady increase in the nation's productivity.

Experience and theory tell us that if the demand for goods exceeds the ability of our economy to produce them, inflation is inevitable. In order to get additional men and machines under these circumstances, producers will have to bid them away from other employment. This increase in cost of production will raise prices, and before you know it, price pressures here and everywhere become strong and general inflation sets in.

There are no "winners" during an inflation. Creditors lose because they are repaid with dollars worth less than those they lent. Savers lose because the dollars they withdraw are worth less than those they deposited. Consumers lose because prices rise. Businessmen find costs higher, planning more difficult, and risk increased due to the greater uncertainty of future conditions. Many of the nation's resources are funneled into wasteful uses.

Higher prices make the goods we sell for foreigners more expensive, reducing our sales to foreigners. On the other hand, their products become relatively cheaper, increasing our purchases from foreigners. At present, such a shift will harm our country because we are already spending more abroad than foreigners spend here.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

So far, I've been talking about prices of goods. But there is another price of equal importance which I have not touched upon: the interest rate. We don't usually think of the interest rate as a price, but it is. It is the price of money.

Through the interest rate, economic and financial conditions are related. This is why monetary policy is so important. And this is where the Federal Reserve System comes into the picture. The Federal Reserve can influence the supply of money and credit chiefly by affecting the amount of reserves available to its member banks. It does this by buying or selling U.S. Government securities or by changing the interest rate the Federal Reserve Banks charge for loans to banks. Since the reserves of commercial banks provide the basis upon which they extend credit, the Federal Reserve System can indirectly influence, to a certain extent, the amount and cost of credit extended.

Just before the 1961 business expansion, the Federal Reserve System started to follow a policy of supplying increasing amounts of reserves to its member banks, chiefly through the purchase of U.S. Government securities. This policy made possible the steady increase in bank credit.

The Federal Reserve System pursued such a policy in order to stimulate economic expansion. Why? Because your desire for goods doesn't turn even one wheel in a factory. Only if you have money and credit to back up this desire do the wheels begin to turn.

In the early sixties the rate of unemployment was relatively high and the nation's factories were operating at less than capacity. Greater demand could be met by starting up idle machines and hiring the unemployed. Increasing the supply of money and credit could stimulate the recovery toward full employment without pushing up prices.

The credit supplementing the savings of the American people and business

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

put more men and resources to work and added to our productive capacity. We rate this expansion of the supply of money and credit an eminently successful policy. But no monetary policy is correct under all conditions, and in the latter part of 1965, conditions began to change. Earlier, as I pointed out, the economy had been characterized by a great deal of unutilized capacity, but in 1965 we were approaching full capacity throughout the country. This led to a rapidly increasing tempo of business activity and thus an upsurge in the demand for credit. Even though savings continued to expand, the acceleration in credit demand was far greater than the growth in supply, leading to an excess of demand over supply. Financial institutions, in other words, had more borrowers at the going rate of interest than they could satisfy.

It is my thesis that the unusually high interest rates which have been arousing so much concern are the result of this increase in tempo. We can certainly all agree that interest rates are now at levels not reached since the 1920's. High-grade corporate bonds and some types of U.S. Government bonds are yielding well over 5 percent. The minimum lending charge on business loans by New York and Chicago banks was recently hiked to 5-3/4 percent, and for most borrowers, is considerably higher. Mortgage rates in excess of 6 percent are common.

Altogether, these interest rate levels are quite remarkable. However, not all of us may remember that prior to recent increases in interest rates, we experienced a period of relatively stable interest rates unprecedented in length for an economic expansion.

Why should this have been so? As long as the supply and demand for money are roughly the same, interest rates will not increase. But interest rates will rise when mounting credit demands exceed the funds available for lending.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

During the early years of the economic expansion, funds available for lending did increase in step with increases in demand. This was made possible by the increasing amount of savings put aside by the general public and the expansionary policy of the Federal Reserve System. But as men and machines became relatively scarce, the demand for credit began to outrun its supply.

Reflecting this situation, interest rates began to creep upward. This, mind you, occurred well before the Federal Reserve's December 1965 increase in the discount rate, which is the rate it charges commercial banks borrowing from Reserve Banks. And so, the primary explanation for the increase in interest rates during the latter half of 1965 must be laid to the rapid rise in credit demand.

Today, even some of the critics of this tightening of the economy's monetary reins are saying the Federal Reserve's December action was taken just in the nick of time. Unemployment was down about as far as possible when there is little unutilized productive capacity. Thus, added purchasing power would raise the demand for goods without bringing forth much increase in production. Bursts of more credit would go in large measure into higher prices as consumers tried to outbid one another for the relatively scarce supply of goods. That such a situation was developing is illustrated by the nation's Gross National Product in the first quarter of 1966. GNP, as we call it, increased by $17 billion from the final quarter of 1965. Yet, this increase, larger than in any quarter experienced in the previous year and largest in many, was greeted--not with applause--but with cries of dismay by serious students of our economy. The reason was that over 40 percent of this $17-billion increase was accounted for by higher prices. The pressure of demand against limited resources had brought about the inevitable result--higher prices. To be sure, some of this increase can be explained by higher prices for food, but this is

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

only a partial explanation.

Another distressing feature of the Gross National Product and income statistics for the first quarter of 1966 was the decline in the rate of consumer savings, the principal source of loanable funds. The ratio of savings to disposable income stood at 4.8 percent--lower than it had been in any quarter in 1965 or during any year of the current economic expansion.

I think we ought to recognize that the Federal Reserve saw the economy rapidly approaching the point where it would press against its physical ceiling on output before others came to the same conclusion. The Reserve Board's action to raise the discount rate was designed to reinforce other efforts to maintain price stability and thus to foster balance in the economy's continued growth. Its purpose was also to strengthen the dollar's international standing--a standing which is endangered by the current deficit in our international accounts.

Since this highly publicized increase in the discount rate came many weeks after other interest rates had risen, it was not, as I have pointed out, the cause for the general rise in interest rates. It was the Federal Reserve's necessary response to rising interest rates charged by other lenders. And these rising interest rates were the monetary signal that we were approaching full use of all our men and machines. Because the Federal Reserve System's responsibility is to foster economic growth and stable prices, it must change its policies when the economy begins to approach the physical ceiling on output. In these circumstances the supply of money must be restrained if the demand for goods is not to outrun the supply of goods.

To meet the challenge posed by other, more profitable uses of funds, the Federal Reserve Board last December also increased the maximum rate of interest permitted to be paid by member banks on time deposits and certificates of deposit.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

This was to make it possible for banks to attract and retain deposits of businesses and individuals and thus to make more effective use of savings funds already available in the economy for financing loan expansion.

More recently, the Federal Reserve Board took further action to restrict credit by making it necessary for some banks to set aside larger reserves. This will reduce possible credit expansion.

Figures covering the second quarter of 1966 indicate that these "medicines" are working. Economic expansion has become less feverish in the past few months. Gross National Product undoubtedly advanced less in the second quarter of 1966 than in the first quarter. The pace of industrial production and personal income has slowed down, and increases in wholesale prices have moderated. These changes imply a noticeable drop in the excess of demand over supply which existed in the last quarter of 1965 and the first quarter of 1966.

This does not mean we are headed for a recession. The economy is still growing. Heavy business investment and government spending promise to continue their support of real economic growth. But the rate of growth has slowed, leading us to hope that growth without inflation--stable, real growth--can be achieved.

In our American economic system, we rely heavily upon the price system to allocate resources between competing users. We prefer this to setting up some kind of board or planning agency to dictate prices and quantities sold. We are convinced that relying upon the price system is, by and large, the most efficient way of getting the job done.

In the present state of our economy, funds are scarce in relation to demand, although, as we have noticed, there has been no actual cutback in available funds. We simply do not have enough to satisfy everyone who wants to borrow.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The American economy has a tremendous economic potential. Given time, I have no doubt that it will be able to supply us with more and more. But we cannot have everything we want right now.

To some extent, the reduced availability of credit can help us bring our demands down to the capacity of our economy. I think we ought to recognize, however, that actions to moderate credit demands alone cannot do the job. This job requires the complete cooperation of business, labor, financial institutions, government, and the Federal Reserve System. Prudence on the part of all may be far more effective than Federal Reserve policy alone and indeed is essential for Federal Reserve policy to work.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis