Pinellas County Speech (9/23/66)
Clearwater, Fla.

INTEREST RATES AND THE NATIONAL ECONOMY

To an astronaut, Pinellas County (Florida) and Fulton County (Georgia) may seem close together, but they are hardly neighbors. Yet they seem like neighbors to me, because I am fortunate enough to have many banking friends and other associates in your great county and the Greater Bay area. Through my association with them, I have come to feel that Pinellas County is just a stone's throw from Atlanta.

We at the Atlanta Federal Reserve Bank try to keep up with what is going on in Pinellas County because we must constantly assess the economic "health" of the six-state region encompassed by the Sixth Federal Reserve District, of which your county is a part. Our diagnosis is that the economic "pulse" of Pinellas County is strong and vigorous. Employment, when adjusted for the summer doldrums, is at an all-time high, and unemployment has dropped to less than 2 percent of the work force, lower than the national rate. In the light of these events, spending during the first eight months of this year, as measured by debits to deposit accounts at St. Petersburg banks, jumped 12 percent over 1965. This increased economic activity placed more demands upon the banks, which provide much of the lubrication to facilitate the flow of goods and services. Those Tampa-St. Petersburg trade area banks that are members of the Federal Reserve System extended 8 percent more loans this August than a year earlier and attracted 9 percent more deposits.

Many of these figures are probably old hat to you, and certainly you don't need statistics to recognize your area's economic advances in recent years. You may even have allowed yourself the luxury of accepting rapid economic gains as a matter of course.

And the vigorous expansion you've experienced here, rather than being peculiar to this area, is typical of that throughout the nation. Phenomenal economic gains have been enjoyed by cities from Maine to California. The entire nation is, as you know, 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 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 we have achieved such tremendous growth without drastic increases in prices 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. A steady increase in the nation's productivity also contributed to this noninflationary growth. Thus, it was possible to avoid inflation.

I have no doubt that this is what our goal should continue to be. Theory and experience tell us that inflation is inevitable if the demand for goods exceeds the ability of our economy to produce them. In that kind of environment, producers who need additional men and machines can get them only by bidding them away from other uses. This increases the cost of production and, in turn, raises prices. And before you know it, price pressures become so strong that general inflation sets in.

Let me remind you that nobody "wins" during 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 lose because of higher costs, more difficult planning, and increased risks 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 more expensive for foreigners, reducing our sales abroad. Moreover, foreign products become relatively cheaper, increasing our purchases from other countries. The end result is unmeasurable harm. Even now, we are spending more abroad than foreigners are spending here. Domestic inflation could do nothing but worsen this situation.

So far, I've been talking about inflation in terms of the price of goods. But another price of equal importance is the interest rate. Although we don't usually think of the interest rate as a price, it is just that. 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. The Federal Reserve can regulate bank reserve positions in any of three ways. It can buy or sell U. S. Government securities; it can change the interest rate the Federal Reserve Banks charge for loans to banks; and it can vary the level of reserve requirements. Since the reserves of commercial banks provide the basis upon which banks extend credit, the Federal Reserve to some extent can influence 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 a steady increase in bank credit.

In pursuing such a policy, the Federal Reserve was motivated by the desire to stimulate economic expansion. The reason for its doing so is obvious. Your desire for goods does not 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 environment of the early sixties, the Federal Reserve had, I believe, every right to be stimulative. You will remember that unemployment then was high and the nation's factories were operating at less than capacity. Production could be easily expanded and demand met by starting up idle machines and hiring the unemployed. The Federal Reserve was aware that by increasing the supply of money and credit, it could stimulate the economy without pushing up prices. The additional credit, along with the savings of the American people and business, put more men and resources to work and added to our productive capacity. Thus, we can rate as eminently successful the policy that generated that expansion in the supply of money and credit.

But no particular monetary policy is appropriate for 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.

The low rate of unemployment was the clearest signal that we were moving toward full capacity operations. In 1960 unemployment had exceeded 6 percent; toward the end of 1965 it was down to 4 percent. Because manufacturers lacked the necessary workers and capacity, they could not keep up with their orders, and unfilled orders were accumulating. In an effort to increase their capacity, manufacturers started stepping up their capital expenditures, producing additional strains on the economy. Defense was requiring more and more of our manpower and resources. The acid test was the way prices were behaving. Rising prices, of course, tell us that demand is increasing faster than the supply of labor, materials, and finished products. Wholesale industrial prices that had been stable during the preceding four years began to move up in 1965, and the previously mild increases in consumer prices started accelerating.

And so, in late 1965, with the economy operating at very near capacity, economic conditions obviously were different from those of early 1961. It was time to change from the relatively easy policy that was designed to get the country out of a recession and put idle men and resources to work, because in late 1965 few men were idle and productive resources were being used at very near capacity. A policy to promote sustainable economic growth and prevent the development of a boom-and-bust situation rather than a stimulative policy became appropriate. Some restraint was in order. Consequently, the Federal Reserve System gradually began shifting to what some people call a tight money policy.

What is a tight money policy? Some of us might answer that it is a reduction in supply of money and credit. However, we are doomed to failure if we try to document this reasoning with actual happenings. More money and credit is being made available today than ever before.

Today I have avoided citing a lot of statistics, but right here I am going to give some figures, because so many people seem to believe that less credit is being made available, whereas the figures show that quite the opposite is true. The easiest figure to cite is one that shows the behavior of the money supply, generally defined as total currency and coin in circulation plus demand deposits. Between December 1965--when the Federal Reserve System first brought the gradual tightening into prominence by raising the discount rate from 4 to 4-1/2 percent--and the middle of this month, the money supply has been increasing at an average annual rate of about 3 percent. In the same period, time deposits have grown at an average annual rate of 10 percent. Loans and investments supplied by member banks have increased at an average annual rate of over 5 percent, and this expansion in bank credit has been supported by reserves supplied by the Federal Reserve System. The System had no intention of cutting off the growth of credit entirely, and it has not done so. Total bank loans have grown at an annual rate of over 12 percent during the first eight months of this year. And bank lending to business has increased at an annual rate of 20 percent.

Nevertheless, despite the growth in credit, we are faced with the undeniable fact that interest rates are now higher than at any time in the last thirty-five years. Surely this must mean that money is tight.

When we remember that interest rates are the price of borrowing and when we also remember that prices result from the operation of both demand and supply, it becomes obvious that demands for credit must have expanded more rapidly than the supply of money and credit. Today tight money is a result, in part, of the greatly expanded demands for credit.

The stepped-up demands have come from several directions. The Federal Government, partly because of the defense effort, has needed more money to spend than it could currently raise from revenue; it has had to borrow, therefore, either directly or through agency issues. State and local governments have expanded their capital spending; they have borrowed. American business this year has embarked on a record-breaking capital expansion program; it has borrowed to meet a major part of the cost. The consumer, until recently, has bought more and more durable goods; he bought a large part of these goods on credit. All these and other forces add up to a record-breaking total demand for credit.

Under such conditions, the only way the Federal Reserve System could have prevented a rise in interest rates would have been to inject enough reserves into the banking system to meet all the increased demands for credit. The System did not do so because such a policy would have promoted an unsustainable boom, stimulated inflation, and made our balance-of-payments problems worse. Instead of enlarging the reserve base to enable the banking system to meet all credit demands, the Federal Reserve System has limited the growth in the credit base.

Some of the several steps taken were less dramatic than others. In December of last year, the discount rate was raised from 4 to 4-1/2 percent. This is the price that the Federal Reserve Banks charge member banks that borrow to replenish their reserves. In addition, the Federal Reserve System has been less willing to supply reserves to the banking system through its open market operations. A measure of this is the figure often called "net borrowed reserves"--the difference for the whole banking system between excess reserves and the borrowings of member banks. A widening of the net borrowed reserve position indicates to some extent the difficulties banks may be having in meeting enlarged credit demands. More and more banks, in order to maintain their reserve positions, have been forced to borrow from the Federal Reserve System; and borrowings, which for the year 1965 averaged $467 million, have gradually increased to their present level of above $700 million. The net borrowed reserve figure, averaging $90 million in 1965, is now above $350 million. Since the Federal Reserve Banks do not encourage individual banks to stay in debt for extended periods and offer borrowing privileges only to cover unexpected contingencies, the effect has been to make the banks more conservative lenders.

Faced with the heavy demand for loans, commercial banks have stepped up their competition for funds, especially through efforts to attract time deposits. The larger banks have used negotiable certificates of deposit, whereas others have tended to develop special consumer-type savings instruments. In an effort to keep this competition from getting out of hand, the Federal Reserve raised the reserve requirements on time deposits and set a ceiling on rates that banks can pay for certain types of consumer savings instruments. It has also asked Congress that additional powers to regulate the rates paid on time and savings deposits be given to the Federal Reserve, the Federal Deposit Insurance Corporation, and the Home Loan Bank Board. A law to this effect has just passed the Congress.

Quite aside from this legislation, the functions of the Federal Reserve System have remained unchanged. These are to foster a flow of money and credit that will facilitate orderly economic growth, a stable dollar, and a long-run balance in international payments. This means the policy must change as economic conditions change. It seems obvious that orderly economic growth cannot be sustained unless demand can be kept within the bounds of the economy's ability to produce. Presently, rising prices tell us that demand is excessive. In the first half of this year, wholesale industrial prices increased at an average annual rate of 3.5 percent. Almost 40 percent of the dollar increase in the gross national product in the first quarter of this year was explained by rising prices; and in the second quarter, almost 60 percent.

Stability of prices during the preceding five years is partly the reason this period of expansion has lasted as long as it has. I am also sure that how long the economy will continue to expand depends upon our ability to hold price pressures down. Even though sometimes we individually profit from inflationary developments, in the long run no one gains from inflation. At the present moment, moreover, with the difficulties in our balance of payments stemming to a considerable extent from a reduction in our trade surplus, rising prices make it more difficult than ever to achieve our long-run goal of a balance of international payments.

No one recognizes the limitations of monetary and credit policy actions by themselves more than the Federal Reserve policy-makers do. Nevertheless, these same policy-makers recognize their responsibilities in making the greatest possible contribution to the achievement of our nation's long-run aspirations. I beseech your help and understanding in the Federal Reserve System's efforts in these difficult times.