QUESTIONS PEOPLE ASK ME

An Address Before the

Rotary Club of Atlanta
Atlanta, Georgia
October 20, 1969

by

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Some weeks ago when I accepted the flattering offer to talk before my fellow Rotarians, I was given the privilege of choosing my own topic. At the time, I thought that I would later decide on my topic as economic and financial developments unfolded. Since then, of course, there have been a great many economic and financial developments that have commanded our attention and that are of great significance to our economy generally and to many of us personally. For example, most recently there has been the international financial strain imposed by the doubts over the future of the German mark, and this followed closely the devaluation of the French franc. Thus, some discussion of international financial problems would be of interest, I am sure. However, international developments are occurring so fast that anything I might say today could well be out of date tomorrow. I reviewed other developments as possible topics for my talk, but it suddenly occurred to me that unintentionally I have been conducting an audience interest survey. Over and over again friends, associates, and other persons with whom I come in contact repeatedly ask me certain questions. These questions will serve as the framework of today's discussion.

Immediately when someone learns that I am associated with the Federal Reserve System, they feel impelled to ask me, "Why are you always talking about inflation?" I must admit that generally any public remarks I make

inevitably touch upon our current inflationary problems. As I shall discuss later, I believe that I have good reasons for doing so.

But, if people do not ask me about why I am concerned about inflation, they will almost always ask me, "When are we going to get some relief from high interest rates?" For example, the other day I made an appointment with my doctor and was anticipating cataloging my major and minor aches and pains in answer to his expected, "How do you feel today?" What happened was that instead of asking me how I was feeling he started with, "Why are interest rates so high?" I felt as if I should be charging him a fee when the appointment was over.

Before I left I explained in the clearest language possible the reasons for present high interest rates. He then asked me, "When will rates go down?"

Lately another question has become very popular. Generally the individual starts the questioning saying, "Isn't it true that. . .?" The questioner will say, "Isn't it true that you have been exercising monetary and fiscal restraint for some time now and prices are still going up? Isn't it true," he will continue, "that rising costs are the true source of inflation? Isn't it true you ought to admit defeat and should adopt some kind of direct wage and price controls?"

To summarize, these are the questions people ask me:

1. Why are you always talking about inflation?
2. Why don't you give us some relief from high interest rates?
3. When will interest rates go down?
4. Why don't you substitute wage and price controls for monetary and fiscal restraint?

I shall touch on each of these in turn.

There was a time not so long ago when you would not have found me always talking about inflation. The nation was enjoying a period of relative price

stability. Wholesale prices, on average, had changed little for several years prior to 1965 and consumer prices had been rising at an annual rate of only about 1 percent. The dollar was retaining its purchasing power.

But, beginning with 1965, price trends changed from stability to steady increases and these increases have continued almost without interruption since then. Since 1964 wholesale prices have risen about 13 percent. Compared with what it would buy in 1964, the dollar today is worth only 88 cents measured in terms of wholesale prices. The consumer has fared even worse with respect to loss in his purchasing power. The rise in consumer prices, as measured by the consumer price index, from 1964 to date, has been over 19 percent. The consumer dollar today is worth only 84 cents in terms of what it would buy in 1964 before the accelerated rise in consumer prices began.

Now the function of the Federal Reserve System is "to foster a flow of credit and money that will facilitate orderly economic growth, a stable dollar, and a long-run balance in our international payments." Price increases in the past four years, therefore, cannot help but be of primary concern to any official in the Federal Reserve System who has even a modest part in policy determination. Such price rises over the long run also are not only harmful in themselves but history has shown that inflation prevents orderly economic growth and achieving a balance in our international payments. Do you wonder why I am always talking about inflation?

Despite the claims of both our friends and critics, the Federal Reserve System does not pretend that its policies are the sole or even the principal force influencing the direction of the economy. Its powers are largely limited to influencing the availability of credit through its control over the amount of reserves it makes available to the banking system.

Nevertheless, the Federal Reserve System has an obligation to use whatever powers it has in making a contribution to creating the conditions that will produce greater price stability.

I have no doubt that there are many persons, perhaps in this group, who are not impressed by the figures I have just cited on the loss of the purchasing power of the dollar. I can imagine that some of them will be saying, "So what? What is so wrong about inflation?" Some of them might say we need inflation to provide for economic growth. Inflation, they say, causes more demand, more jobs, and general prosperity. I am afraid that many persons believe this. Otherwise, we could expect a more enthusiastic support in efforts to curb inflation.

To some extent this attitude of tolerating, if not supporting, inflation results from inflation being such a great deceiver. We Americans like to show progress and we generally measure this progress in terms of dollars. Corporate executives, for example, like to show that their earnings per share are greater year after year. Labor union officials like to be able to show their members how much the union has improved the average wages of its members through its bargaining. And there are many others who desperately want to show larger dollar figures at the end of any period. Although there in the back of our minds we may realize that the dollar is not a consistent unit of measurement so long as prices are rising, we very frequently forget this. Inflation means bigger and bigger dollar figures. These inflated dollar figures thus create a feeling of euphoria. To this extent, we really enjoy inflation.

My friends, as pleasant as this feeling may be, it cannot continue forever. Past experience, not only in our own country, but in other countries throughout the world demonstrates that the public cannot be deceived by inflation forever. Eventually, continued inflation is recognized as the great

deceiver that it is. Eventually, the public realizes that it destroys the value of our savings, that it distorts the pattern of investment, that it upsets the international value of our money, and that it imposes injustices upon a large part of our population. Indeed, as we have seen lately, inflation may topple seemingly strong governments.

There are, of course, some persons who manage to come out on top in an inflationary period. These may be astute speculators or they may be persons who always seem to profit from the misfortunes of others. But for the vast majority, continued inflation is a great misfortune. This applies especially to the poor, but it may also apply to the rich as well.

In mid-1969, the average welfare payment in Georgia to families with dependent children was $24.55 per month. This figure is indeed low but ostensibly it was some improvement over the $22.09 figure for 1964 before prices began to rise sharply. But let us see what happened to the purchasing power of that $2.46 increase. In 1969, $24.55 will buy only what $20.62 would buy in 1964. The recipient has lost $1.33 in purchasing power, not gained $2.46.

Let me give another example. Most of us are happy that it has been possible to raise the social security benefits to retired workers. In 1964, I am told, the average monthly payment was $77.57. Today it is $99.47. But here again inflation has been a great deceiver. Today's payment will buy what $83.55 would buy in 1964. Thus, the increase was only $5.98 in 1964 consumer dollars, not $21.90.

Inflation has robbed the manufacturing worker of a major part of his higher earnings. Average weekly earnings in manufacturing for the United States were about $130 in mid-1969. In 1964, they were $103. Thus, the average pay increased about $27. Measured in dollars of 1964 purchasing power, however, the increase is reduced to $6. Even more significant

is that during the past year, despite an increase of about $6 in average weekly earnings in manufacturing, the average weekly earnings in 1969 actually bought a little less than in 1968.

I assume there are at least some Rotarians here today who are enjoying incomes that put you in the high tax brackets and that part of the incomes come from investments made in interest-bearing securities. Let us suppose you are in the 30-percent bracket. Let us suppose further that somehow or other you have found a place to invest funds to yield an interest rate of 10 percent. But inflation has robbed you, too. If the calculations published by the Machinery and Allied Products Institute are correct, your real return after taking into consideration taxes and a 5 percent inflation would be only 1.9 percent.

When am I going to stop talking about inflation? Just as soon as the nation achieves price stability.

II

"What is all this to do with high interest rates," you may well ask. Furthermore, you quite often have asked me, "Why don't you give me some relief from high interest rates?"

Rising prices, as you well know, are a symptom that effective demand is greater than can be satisfied by the nation's productive resources at constant prices. It is elementary that a further increase in this demand will push prices up further. Under conditions of nearly full employment anything that adds to the purchasing power of the nation adds to the pressure on prices.

Now interest rates, of course, like prices of commodities and services, are determined by both supply and demand. The price of money, interest rates, is determined by the supply of and demand for funds. The Federal Reserve System's influence on interest rates comes from its ability to change the

availability of member bank reserves. As reserves made available to the banks shrink, the banks find it difficult to supply credit to individuals, businesses, and governments. With a strong demand for credit, rates rise.

The Federal Reserve System could prevent rates from going up by supplying more reserves. But when you increase reserves to the banking system and indirectly increase the availability of credit, you also increase the purchasing power in the hands of individuals, businesses, and governments. Adding purchasing power under the conditions of inflationary pressure that prevail today in an effort to lower interest rates would result, of course, in even more rapidly rising prices.

That more credit does not automatically create more goods when you have conditions of full employment is dramatically illustrated by what has happened to the nation's gross national product, measured in terms of current and constant dollars. Total spending, as measured by the GNP in current inflated dollars rose about 7 percent at an annual rate in the second quarter of this year. But most of this increase was explained by rising prices. Measured in dollars of constant purchasing power, the increase was at an annual rate of only 2 percent.

You have a choice. Would you rather have lower interest rates and continued inflation, or would you rather have, for a time, high prices for the money you borrow with some hope of getting inflation under control? We believe that the Federal Reserve System has the responsibility for choosing the latter course.

III

I should be guilty of gross misrepresentation if I were to attempt to set any specific time table as to when interest rates will come down. I can, however, point out the kinds of conditions and circumstances under which a

decline in interest rates seems likely to occur. First of all, interest rates will come down when you fellows stop borrowing so much money, or in the words of the economist, when the demand for credit drops off. Contrary to what is sometimes supposed to be the case, tremendous amounts of funds had been borrowed in the credit markets. Corporate securities offerings in the third quarter of this year, although down a little from the second quarter, totaled about $2.1 billion, up $400 million from the corresponding quarter in 1968. State and local governments borrowed heavily in the second quarter of this year, for a total of $1.6 billion, although there was a sharp reduction in the third quarter to $1 billion. The demand for mortgage funds has apparently exceeded the funds available but so far this year in support of the residential mortgage market, the Federal Home Loan Bank System has raised about $2.4 billion in the money and capital markets. Although the Federal Government has not been a net borrower so far this year because of a relatively favorable budget position, direct borrowing by Federal agencies has increased sharply. Loans made by commercial banks continued to increase in response to heavy credit demands with business loans up in the third quarter of 1969 at an annual rate of about 4 percent.

Thus, any softening in the demand for funds, would reduce the pressures on interest rates. For example, the desire to obtain funds for business plant and equipment expenditures has been one of the chief sources of the demand for credit. Interest rates will decline, therefore, when these expenditures slacken. The demands of the Treasury for funds will, of course, depend upon the U. S. budgetary position. A budgetary surplus, therefore, could do much to lower the total demand for funds.

But some of the demand for funds has come from individuals and businesses who borrow because they expect that inflation will continue forever. Let me be

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quite frank on this point and say that I speak solely for myself. If the Federal Reserve System is going to convince the general public that inflation will not last forever, it will need to hold fast to a firm policy, not only until some of the pressures begin to ease, but until we have clear evidence that the job has been accomplished. Removing restrictions too soon can be as bad as holding onto them too long. Interest rates will eventually decline when credit demands soften and inflationary expectations subside. Winning the fight against inflation, therefore, is a key to lowering interest rates.

But there are some people who feel that we should be making more progress towards getting inflation under control than we have at this time. They expect and want an instant solution. Now, of course, it can be said that inflation has taken some time to develop and that we should expect it to take some time to diminish. We, of course, have the lessons of history which show us that it takes several months for the restrictive monetary policy to be effective in bringing about a halt in rising prices. But we also need to remember how soon rising price trends will end depends on the type and severity of the restrictions that are being imposed. The Federal Reserve's efforts have been applied to applying the brakes gradually in order to contribute towards a more orderly and sustainable rate of economic growth. Policy is not designed to bring about a recession. Although a deep recession might bring about a halt to rising prices, it would also create a great many other problems.

Contrary to what some persons imply, evidence is developing that restrictive monetary and fiscal policies are gradually taking effect.

Monetary restraint, of course, is most clearly evident at the commercial banks and especially at the larger banks. Total bank credit at all commercial

banks has changed little during the past four months. With their loanable funds limited, banks have been forced to become more selective in extending loans. Total bank loans increased at an annual rate of about 11 percent during the first five months of this year and increased at an annual rate of about 2 percent in the June-September period.

These and other financial developments have had an impact on spending and plans for spending by individuals and businesses. Retail sales, as you know, have been relatively stable lately and there was some curtailment in expansion plans for new plant and equipment as suggested by recent surveys of intentions. Other definite signs of economic cooling are cropping up. Thus, although we have no assurance that the process of cooling off has progressed to the point that we can relax restrictions, we can be sure that it is beginning to take effect.

As for prices, wholesale prices in September rose at an annual rate of only 1 percent after having risen substantially more during the early part of the year. During the first half of 1969, wholesale prices rose at an annual rate of over 4 percent. Part of the slowdown results from the softening in farm and food prices, of course. In September industrial wholesale prices rose at an annual rate of 4 percent, a rate still excessively high but somewhat lower than early this year. Consumer prices are still rising more rapidly than we should like. The August rise at an annual rate of about 5 percent, however, is somewhat lower than the preceding several months.

Recent economic and financial developments suggest to me that the monetary policies gradually imposed have begun to gradually take hold, but inflationary pressures are still strong. Consequently, it would, in my opinion, be extremely unwise to abandon a policy that is beginning to work for one of

direct wage and price controls that from all past experience seems unlikely to work.

I am sure that many businessmen who have suggested direct wage and price controls as a substitute for general credit policies have not thought through all the implications of such a program. This is so because I don't believe that businessmen generally would welcome a harness of controls that would extend from the top to the bottom of their businesses and that would substitute the decisions administrators for their own judgment.

Perhaps the less frequency with which this solution is being suggested today compared with a couple of months ago may indicate that more businessmen are realizing what might be the consequences of a program of direct wage and price controls.

As for myself, I am opposed to a system of direct wage and price controls because it runs contrary to my general philosophy and because I believe it would inevitably result in a failure. Philosophically, I am opposed to direct controls because such a system would eliminate economic freedom. I am convinced that despite its imperfections our present market-oriented economic system has more chance of satisfying the legitimate wants of our citizens and of promoting economic growth than any system that can possibly be conceived by a group of administrators. Furthermore, I have yet to be shown where a system of direct controls has been an outstanding success. If you are looking for an example of the difficulties and distortions involved in this system of direct controls, you have only to study experience in this country during and after World War II. Those were relatively favorable times when public support on the grounds of patriotism could be relied upon. Today, I believe, we could not count on that kind of support.

Another misconception is that direct controls would be a complete substitute for general monetary and fiscal controls. Somehow or other, some people seem to believe that if you had direct wage and price controls you would not have any restrictions on credit. Some persons suppose that they would be able to get all the money they wanted at low interest rates. On the fiscal side, they seem to think, there would be no need to balance the Federal budget. As a matter of fact, the only chance that direct controls might have of having even mediocre success would be as a supplement to and not as a substitute for general controls. General controls would still be used to limit excess demand which is the basic cause of inflationary pressures. We would, therefore, likely find ourselves with direct controls on top of general monetary and fiscal controls.

Perhaps persons advocating direct controls naively believe that they will be selective and will pick on someone else instead of on them. Perhaps the businessman hopes that controls will be imposed on wages and on the prices of the things he buys, but will not be imposed on his profits and the things he sells. But you and I know that once started there will be no limit to the facets of our economy that would eventually to be placed under restrictions and controls.

Someone has said that this nation gets the kind of economic and monetary policies that it deserves. I presume this means that without a fairly general support from the public no monetary or economic policy, as good as it may be, theoretically, stands any chance of working. To work, any policy must have general public support. The unwillingness of the American people to accept the kind of economic discipline that is needed and the conflicting pulls of special interests are responsible for a major part of our troubles today.

I find it difficult, therefore, to believe that a nation that is becoming restive under restrictive monetary and credit policies that leave almost complete economic and financial freedom in the decisions of how to spend the available financial resources would submit to a program that would transfer decisions to governmental agencies.

Why am I always talking about inflation? It is because it is not only the function of the Federal Reserve System to contribute to maintaining price stability, but it is because continued inflation places the burdens on the less fortunate members of our society and in the long run is an obstacle to economic progress.

Why don't we give you some relief from high interest rates? It is because to do so would only add inflationary pressures under present conditions.

When can you expect interest rates to come down? We can expect interest rates to come down when the inflationary pressures are brought under control and the credit demands can be more nearly satisfied by the financial savings of the nation.

Why don't I advocate adopting direct wage and price controls? It is because I believe they are not only unworkable but because they are incompatible with a free economy.