(Minnesota Bankers Association, St. Paul, June 11, 1957)

PUB 1
Mr. Deming

TODAY AND TOMORROW

The title of my talk today should give me wide enough latitude to talk about almost anything. It was not chosen for that purpose, however, but was selected deliberately as the background theme for a talk dealing broadly with three topics: "tight money", "economic resources", and "creeping inflation".

Let me tell you first what I mean by the background theme of "Today and Tomorrow". In the United States today we find the economy operating at a very high level. In terms of industrial plant and labor force it is operating at close to capacity. Employment is at record levels, unemployment is very low, personal income is at an all time high. The gross national product, the dollar value of all goods and services produced in the economy, is running at an annual rate of $430 billion. For the full year, 1956, the national product totalled $412 billion. By any reasonable standard of measurement the American economy is operating on a full-employment basis; since the beginning of World War II it has shown great strength and resiliency, and despite a mild dip or two, it has grown steadily.

This economy of ours can continue to grow and can continue to show great strength and resiliency as the years advance. Long range forecasts - for 1965 and 1975 - indicate a growing population working with rising productivity to produce more goods and services and earn more income. A gross national product of $500 billion is well within sight now. Projections for 1975 indicate that a national product of more than $700 billion could be attainable at that time. ~~but~~ These figures are in terms of current prices; they do not reflect any possible price inflation.

This Central Northwest is a great geographic area, rich in natural resources - agricultural, mineral and forest - with a strong people to work those resources. In the Twin Cities there has been created a virile industrial, commercial and financial complex to serve the area and to add to its basic strength. For the

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

area as a whole, population is sparse but there is a lot of room to grow, and growth can and will come. The Central Northwest should share in the growth forecast for the country and, if we work hard, can grow a little faster.

Tomorrow, in both nation and area, can be even brighter than Today. Such is my background theme. Now let me relate that to the three topics: "tight money", "economic resources", and "creeping inflation".

The link between the background theme and the three topics is capital investment and saving. To get tomorrow's level of output, with more people working with higher productivity to produce more goods and services and earn more income, will require substantial growth in our capital investment - in industry, in agriculture, in mining, in forestry, in transportation, in power, and so on. To permit the capital investment needed will require continued use and perhaps growth in the rate of savings. To induce the necessary level of saving under our system of enterprise requires a stable dollar.

The primary purpose of the Federal Reserve System is to regulate the supply, cost and availability of bank reserves, thereby influencing the volume, cost and availability of money and credit in the economy. The System attempts to carry out this primary purpose so as to produce a reasonable balance between the amount of money and credit and the amount of goods and services in the economy which will lead to a high level of employment, a rising standard of living, and maintain a stable dollar.

"Tight money" is the reflection of credit demand outrunning available credit supply. It occurs when credit supply is reduced below credit demand or when credit supply does not increase as much as credit demand. The latter situation is typical of a boom and it is just what has occurred the past couple of years. The supply of credit has increased but the increase has not been large enough to meet the increase in demand.

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

To put the whole credit picture in perspective, it is well to remember that the total volume of public and private debt in this country is close to $700 billion, with bank credit outstanding about $170 billion. For the past few years annual increases in debt have averaged $30 billion; in 1955 the rise was $50 billion. Most of this debt increase was financed by savings, but from $4 to $10 billion each year was in the form of bank credit. When savings finance debt expansion the money supply is not increased; when bank credit finances debt growth, the money supply grows also. Unless an equivalent amount of goods and services results, the net effect of an increase in the money supply is likely to be higher prices.

Let us examine this situation a little more thoroughly by considering the nature and supply of economic resources. These resources consist of raw materials, of processing and distributing systems, and of the labor force, the people who produce goods and services. At any given point of time the supply of these resources is limited. As a matter of fact the very nature of economic resources is that they are relatively scarce. An important part of the field of economics involves study of the efficient use of scarce resources so as to "economize" in their use.

Now the supply of economic resources can be increased, of course, but the process takes some time. Population grows and more people can be found for the labor force, but this involves time. Plant and equipment can be added to existing capacity, but this involves time. Raw materials can be exploited more thoroughly, but this involves time. In other words, when an economy is operating at close to capacity, the mere fact that people want more goods and services will not produce those additional goods and services overnight. The additional demand can be met only when capacity to produce is expanded. Perhaps the most dramatic illustration of this kind of situation arises during wartime when the demands of the civilian economy are cut back by rationing so that military demands can be met.

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

When the economy is operating at substantially less than capacity, an increase in demand, arising either from income or from credit, may call more existing capacity into active use without any appreciable effect on prices. But when the economy is operating at close to capacity, an increase in demand generated not from income or saving but from credit merely increases the supply of money and does not quickly and in equivalent size increase the supply of goods and services. Thus more money chases about the same supply of goods and services and the major effect is rising prices.

Fundamentally, ever since World War II closed, the ~~Federal Reserve~~ UNITED STATES has been faced with a situation where demand was outrunning capacity. There have been brief periods when the economy was in a downtrend, but the major trend has been upward and inflationary. This has been particularly true of the past two years and is the fundamental cause of the so-called "tight money" condition. Money is tight because there is greater demand for it and the growth in the supply has been held down.

There seems to be ~~a body of~~ some opinion in this country which holds that the "tight money" problem would be solved if Federal Reserve policy would be relaxed so ~~as to let~~ that the banking system could have all the reserves it would need to meet all demands upon it. ~~Many~~ Some people seem to think that if there were more credit available we could have more housing, more roads, more schools, more plant and equipment, more autos, and more everything. The hard fact is that increasing the supply of credit now would make nothing but money more available. The larger supply of money would not bring out more resources in the short run, but it would bring higher prices. And it would not even cure the "tight money" situation. For with higher prices even more money would be needed to command the goods and services and to finance transactions. Supply would still be <u>relatively</u> smaller than demand. The only way to cure the "tight money" situation is to bring savings and investment closer into balance either by increasing savings, or by cutting back investment, or by a continuation of both.

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

It is sometimes asserted that failure to permit credit to expand so as to satisfy all demand results in some people being hurt and benefits only lenders of money through higher interest rates. It seems to me that this is a matter of words rather than of facts. It is perfectly true that a restrictive credit policy leads lenders to screen their credits more carefully and results in some rejections of loan applications, and that somewhat stiffer terms keep some borrowers out of the market. This is exactly what a restrictive credit policy is supposed to do; if it did not do this, it would not be restrictive nor would it be effective.

Under our system of free enterprise we allocate scarce resources through the price system. This procedure is supposed to and, in fact, it does tend to let the more efficient users of resources obtain them, and thereby leads to a maximum level of total output. Resources may be allocated in other ways, but they have to be allocated in some way. There is no system of resource allocation that will permit allocation of resources that do not exist. On the record, our system seems to lead to the best general resource use; at least it leads to the highest standard of living in the world.

Insofar as this credit screening process leads to some prospective borrowers receiving less than they wish and thereby keeps them from bidding up the prices of scarce resources, it would seem to help rather than hurt the economy. Unless the process leads to unemployment generally it can scarcely be said to be harmful. It may, indeed it should, lead to some demand being deferred until a later time.

Because of the belief that a restrictive money policy hurts some people there is always a certain amount of agitation for special protection or shelter for particular groups of borrowers. Quite often this takes the form of statutory maximums on rates to be charged borrowers. Schools are important; therefore credit should be supplied school districts, but school districts should not be permitted to pay more than so fo Small business is important, agriculture is important, housing is important; therefore credit should flow to these fields at low rates. No one can disagree with the feeling that credit should flow to these uses when worthy borrowers in these fields seek credit at the market. As a matter of fact, a considerable amount of credit always has and always will flow to them. And in many cases this credit flows to them under the broad protective cover of Government policy aimed at helping them.

Two observations seem pertinent at this point. First, while it may be public policy to shelter some borrowers, it should be recognized that in a democracy with a free market all borrowers cannot be sheltered. And to shelter some means that they are given preferential call on resources and others have to scramble harder to control them. Second, many of these borrowers might get along much better if the type of shelter provided were not in the form of legal maximum interest rates which they can pay. Where these borrowers have been permitted to pay going market rates for funds they have found no particular shortages of credit.

And that leads me to a comment about interest rates in general. I have said that Federal Reserve policy has aimed at holding down credit expansion. This action, in the face of strong demand, has resulted in higher interest rates. The volume of money and the level of interest rates both cannot be stabilized at the same time under our system of free enterprise. If the supply of money is maintained in balance with economic resources, then the level and structure of interest rates must vary in keeping with the strength of credit demand. In fact, appropriate rates are those which help bring the demand for credit and the supply of savings into equilibrium.

If these higher rates accomplish this, they benefit the economy generally. The other day, in a talk made here in St. Paul, Governor Balderston of the Federal Reserve Board cited a very significant case with respect to State and local government expenditures. First he noted that despite higher interest rates, the cost of borrowing money for state and local governments

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

amounts to only 2 per cent of their total expenditures. Then he gave two alternatives for capital investment in the year 1965, assuming the same physical volume in each case. In case A, however, interest rates held constant at about 3 1/2 per cent, but prices rose 2 1/2 per cent a year. In case B, prices held constant but interest rates rose to 5 per cent. The total cost with stable prices but higher rates would be roughly 10 per cent smaller than it would be with rising prices but stable interest rates.

Now let me turn to the last topic I wish to discuss, "creeping inflation". There has been a lot of talk recently that a price rise of 3 per cent a year is not too high a price to pay for easing the "tight money" situation, and that it actually would be good for us to have such a "mild" price rise because it would stimulate business. There are others who argue that such a price rise will come anyway, so we might as well face the facts. It will come, this latter group says, because rising costs will force it.

I am in disagreement with both of the schools of thought. I must admit that despite a restrictive monetary policy in 1956 prices rose about 3 per cent and the economy did not collapse. I should point out, however, that this development meant that half the increase in the national product from 1955 to 1956 reflected higher prices rather than real output. And I should point out further that prices had held very steady for the preceeding five years, so that the 3 per cent in 1956 did not come on top of 15 per cent for the past half decade.

But a price rise of 3 per cent per year compounded would mean that prices would double every 25 years, and I submit that this would be a very high price indeed. To put this in another, perhaps more significant way, it would mean that the value of our money would be cut in half every 25 years. It would mean that there would be little or no incentive to save and consequently it would mean that the chances of balancing saving and investment would become quite remote. Who buys a 25-year bond if the money he gets back at maturity is worth just half as much as it was when the bond was bought?

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

In the second place, I would have grave doubts that "mild" price rises could be kept "mild" forever. With the incentive to save diminished, the incentive to spend would grow. And with easy credit, rising prices and stronger reasons to spend, the "creeping inflation" of a 3 per cent rise per year very likely would become soon a walking and then a running inflation. At least this has been the record of history.

Neither do I think such an annual price rise inevitable. Sound fiscal and monetary policy coupled with public support and acceptance of such policy should keep the value of the dollar relatively stable. It will take work and courageous action but it can be done if there continues to be public support.

And now I come full circle and back to my original theme of Today and Tomorrow. If we can keep our dollar stable we can better secure the saving to finance the investment which will make possible a very bright tomorrow. We are doing reasonably well today. I hope that the promise of tomorrow can be made real.

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