

Talk given by Frederick L. Deming, President of the
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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.

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.

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 changes about the same supply of goods and services and the major effect is rising prices.

Fundamentally, ever since World War II closed, the 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 some opinion in this country which holds that the "tight money" problem would be solved if Federal Reserve policy would be relaxed so that the banking system could have all the reserves it would need to meet all demands upon it. 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 relatively 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.

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.

In so far 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.

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?

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.

To conclude this talk, I would like to read you three paragraphs from the recent report of the Subcommittee on Fiscal Policy of the Joint Economic Committee of the House and Senate. Congressman Mills of Arkansas is Chairman of this committee, and other members of the subcommittee are Senators Douglas, O'Mahoney and Goldwater, and Congressman Curtis of Missouri. The report says in part:

"Inflation is a grave economic problem facing the American economy today. Failure to deal with it forthrightly will result in increasing hardships for millions of Americans. It will impose the costs of economic instability on future generations by making achievement of steady economic progress increasingly difficult.

"The basic problem is an inadequate level of savings out of current income. An ever-increasing volume of real savings is needed to meet the economy's requirements for replacement of plant and equipment under inflated prices and for growth based upon full exploitation of rapid technological advances. Fiscal and monetary policies should be directed toward encouraging a higher level of voluntary real savings under the present conditions of inflationary pressure.

"Since these objectives have not been fully accomplished, public policies to cope with increases in the price level must take the form of general fiscal and monetary restraints on the expansion of total spending. It is recognized that the burden of such restraints may not be evenly distributed throughout the economy. The burden of inflation, however, is far more inequitably distributed. The alternative to general fiscal and credit controls is some form of direct government control over wage and price determination. The use of this type of control would produce results as bad, if not worse, than the inflation against which it would be directed, and should be avoided."

In a nutshell, these paragraphs say pretty much what I have been trying to say this noon. I think that they underline the scope of the job the Federal Reserve System faces today. They underline the reasons for the policy of credit restraint which has been followed by the System for the past year and a half. This policy needs public understanding and public support to be effective. So far it has enjoyed a good measure of support. I hope it can continue to do so.