

MONEY MATTERS

The title of this talk tonight is Money Matters. You can say that in at least two ways, accenting either the first or second word. Say Money matters and you stress the idea of facts relating to money; say money matters and you stress the importance of money. I am going to stress both words and talk about both fields - facts and importance.

It is perfectly natural to talk about money in our kind of economy because we operate a money economy. Money serves as a medium of exchange. We are able to specialize in activities and thereby increase productivity because we are paid in money for our efforts and use the money to buy goods. Money also serves as a store of value. We can save or we can make future commitments in money. Particularly, in respect to this latter function is it important to have stability in the value of money.

Left to itself, money never has behaved very well. Over one hundred years ago a famous British economist stated that money will not manage itself. All that we have learned about money in the last century indicates that the economist was completely correct. Throughout history the major job of a central bank has been money management. This was just as true under a fully convertible gold coin standard as it is today when currencies are merely backed by gold.

The Federal Reserve System is the central bank of the United States, and in talking about the facts concerning and the importance of money, I am going to talk about the Federal Reserve and about Federal Reserve policy which is monetary policy.

It is interesting, and sometimes disconcerting, to note that monetary policy is not only a pertinent topic but that it has become almost a topical topic during the past dozen years. Almost ever since World War II closed monetary policy actions have been front page news. To the central banker of a century ago,

or even to one of the past generation, this would be almost indecent. Outside the rarefied circles of high finance and government, monetary policy just was not discussed. It might have some references in the financial press or on the financial page, but never on the front page.

The fact that monetary policy action can be and quite often is front page news now reflects much better public understanding of its function and its importance. This is really all to the good and I hope that the understanding can be continued and broadened. Unfortunately there is a lot of misunderstanding, or imperfect understanding, also and this has led and may continue to lead to some difficulties.

Perhaps the major difficulty engendered by imperfect understanding is attributing too much importance to monetary policy. To read some press stories, or listen to some talks, you would get the impression that monetary policy was (a) a panacea for all economic ills and/or (b) such a powerful economic force that no one should be entrusted with it. Of course it is neither. It can be, and I think it has been, a powerful force for economic stability. All by itself, however, it cannot prevent inflation nor cure depression. Nor, all by itself can it cause inflation nor create depression. No central banker ever claimed that it could. It is important but it is not all-important.

A second difficulty coming from imperfect understanding is that (a) the Federal Reserve is part of the administration, and that monetary policy is dictated by the administration, or (b) that it is completely independent and responsible to no one. Again, neither (a) nor (b) is correct. The Federal Reserve Act is designed to insulate the System from the day to day pressures of partisan politics, because monetary policy is not made very well unless it is so insulated. The Federal Reserve is not independent of Government, however; it has never claimed to be anything but what the law says it is, responsible to the Congress which created it and to which it renders its annual reports. The "independence" which the System claims is independence within Government, freedom

to have its voice heard. It is a public institution with public responsibilities and its policies are framed in the public interest.

On balance, the fact that monetary policy news is now front page rather than financial page news has been of benefit to the Federal Reserve. More understanding, and that is what we really have nowadays, has brought with it fairly widespread public support and this greater understanding and support has helped it to do a better job.

Now, let me comment briefly on the most recent front page news about monetary policy - the action of eight Reserve banks to reduce their discount rates from 3 1/2 to 3 per cent. These actions may be interpreted as reflecting a feeling in those banks and in the Board of Governors that the pressures of inflation had declined to a point where it was no longer necessary to pursue as restrictive a monetary policy as had been pursued. The fact that other Reserve banks still have 3 1/2 per cent rates posted reflects either one of two situations: their Boards have not met to take any action or they do not feel so strongly about the abatement of inflationary pressures within their districts. Generally speaking, the Reserve bank discount rates tend to move together but with some difference in timing because of differences in timing of Board meetings and differences in timing with respect to economic developments in the various districts.

I believe the most pertinent comment to be made about the recent rate actions is that they demonstrate dramatically the fact the monetary policy is flexible and changes in the light of economic conditions. System people have been trying to say this for a long time. Sometimes we are accused of favoring tight money and high rates. Sometimes we are praised for these. Sometimes we are accused of favoring easy money and low rates. Sometimes we are praised for these. In point of fact we favor an expanding economy, a rising standard of living and a stable dollar, and our policies are aimed at these goals. Depending on conditions, these policies may result in tight or easy money, in high or low rates. We favor neither any more than a doctor favors surgery as against rest,

depressants as against stimulants. He prescribes to meet conditions as he finds them. We try to do this also.

Now, for the balance of this talk I want to discuss the rationale for monetary policy, note some of the basic criticisms aimed at it today, and try to answer some of those criticisms. Most of this discussion will be against the background of restrictive rather than easy monetary policy. There are several reasons for this. First, since the past fifteen years have been mainly characterized by inflationary developments, a restrictive policy has been called for most of the time, and the recent record is perhaps more understandable than that of an earlier period. Second, the impact of a restrictive policy is more easily seen than that of an easy policy. And third, most criticism results from the impact of a restrictive policy.

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 increased but the increase was not 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 chases 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 has been tight because there was greater demand for it and the growth in the supply was held down.

There seems to be some opinion in this country which holds that the "tight money" problem would have been solved if Federal Reserve policy had been relaxed so that the banking system could have had all the reserves it would need to meet all demands upon it. Some people seem to think that if there had been more credit available we could have had 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 would have made nothing but money more available. The larger supply of money would not have brought out more resources in the short run, but it would have brought 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 a "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. To some degree this is what has happened.

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.

The critics of monetary policy, particularly during the past two years, have levelled two basic charges against it. In a sense these charges are paradoxical, especially so when advanced simultaneously by the same critic, because they come down to a charge on the one hand that monetary policy is ineffective and on the other hand that it is too effective.

The case against monetary policy as being ineffective runs about as follows: General credit policy to be effective has to be very severe. It cannot be made acceptable if it is so severe because it will bring about depression and unemployment. If it does not do this, the demand for labor brings about pressure for higher wages which react on costs. The higher costs have to be passed on in the form of price increases. Monetary policy cannot affect these. Therefore, there are only two possible courses to follow: a series of direct controls on wages, prices, etc., so as to stop the wage-price spiral, or acceptance of creeping inflation. As a footnote to this line of argument, it is said that inflation results from too much money relative to the supply of goods and services. To increase the supply of goods and services means more production. A restrictive

credit policy inhibits production and thus is self-defeating.

The case against monetary policy as being too effective tends to take the line that it discriminates against the little fellow, against small business, the farmer, small municipalities, etc. The argument runs that credit policy works but it works inequitably and that means the cure is worse than the disease.

Now, I must admit, as I did earlier in this talk, that monetary policy cannot do everything. Obviously, a restrictive policy with respect to credit cannot prevent Government from running a deficit, labor from demanding higher wages, and business from seeking higher prices. I wish to make two points, however. First, a restrictive monetary policy does not necessarily aim at cutting back on credit; most of the time it aims at restricting the rate of growth. It does not attempt to nor need to work except at the margin. To the degree that it results in holding down demand, it is marginal or less efficient demand that is held down. Second, there is a vast difference between acquiescing eagerly in underwriting a wage-price spiral by permitting unlimited money creation, and resisting or inhibiting it by holding down increases in the money supply. The latter course does snub the spiral by holding down growth in total demand and by creating more cost-price pressure, thereby intensifying resistance to the spiral. You cannot have wide open inflation without sharp increases in the money supply; price rises can be minimized by restrictive credit action. On the record, this has happened over the past five years in this country, and it has been accomplished with rising production and very high employment.

Now, a final point on the ineffective argument, especially that phase relating to the use of direct controls. Here we come back to the basic problem of resource allocation. The direct control method is foreign to our kind of political economy, except under emergency conditions, which is a strong point against it. But, over and above that, the fact is that neither we nor anybody else ever has made the direct control method work very well. Substituting the judgment of a few, no matter how intelligent or well-intentioned, for the judgment

of the market as a whole, has not led to very efficient resource allocation.

Now as to the too effective argument, the case that a restrictive policy penalizes the little man but does not affect the big borrower. As often as this charge is made, it has never been documented and thus I think it merely fair to say it has not been proved. On the contrary, such evidence as there is seems to run the other way. I might note that, at the behest of the Congress, the Federal Reserve is engaged at present in a major survey of small business financing during a period of restrictive credit policy. I hope that this will yield concrete information on this point and resolve it one way or another.

Let me cite here just a few figures which seem to me to indicate that smallness is not too significant a factor in respect to credit availability, and it should be noted that in some cases it is not even a factor in respect to credit cost.

In the fall of 1955, the System conducted a major commercial bank business loan survey. Loans were classified by size, by type and size of borrower, by interest rate, by term, and so on. In the Ninth Federal Reserve District 54 per cent of the total number of loans went to borrowers with total assets of less than \$50,000. Note that this is not net worth but total assets. While it is difficult to define small business, and the definition varies with respect to different kinds of business, I believe everyone would agree that concerns with total assets of less than \$50,000 were all small business.

These borrowers received a little more than 10 per cent of the total dollar amount of business loans extended by Ninth District banks. They accounted for a little less than 10 per cent of the employment in Ninth District business. If we can use employment volume as an indicator, it would seem that small business got a little more than its "fair share" of business credit from Ninth District banks in late 1955. This is not a conclusive case, of course, but it certainly does not point up any opposite case either.

Earlier this year, the System did a little study of municipal financings, attempting to determine whether small issues faced greater marketing difficulties and higher interest costs than large issues. Now this study indicated that high quality issues sold more easily and at lower rates than poor quality issues. It showed also that the total cost for a large issue was proportionately smaller to the amount of the issue than that for a small issue. But, isolating the pure interest rate factor gave an interesting result. Of 400 small issues for which comparison of interest costs could be made with large issues of comparable quality, 26 per cent showed no significant difference in rate, 37 per cent had higher rates, and 37 per cent had lower rates. Again, while this does not prove the non-discrimination case, it certainly does not point to discrimination either.

In point of fact, the argument that there is discrimination is pertinent only if this leads either to inefficient resource use or runs counter to public policy. Actually, as a matter of public policy, we in the United States have provided certain sheltered markets for various kinds of borrowers and thereby have discriminated in their favor. Generally speaking, we have done this in three ways: through tax exemption - for example, municipal bonds; through creation of secondary markets by legislative action - for example, Fanny Mae; and through subsidy - for example, the provision of federal funds for state highway programs.

In a very real sense, creating these sheltered markets has resulted in discriminating against those who do not have this advantage. Unfortunately, there is no known process for making a sheltered market for everyone.

Now in conclusion, let me say again that monetary policy is much more widely discussed and much better understood today than it was a generation ago. This better understanding has helped make it work better, because it has led to general public support. I believe the record of the past decade has been reasonably good; I hope it can continue to be good.