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THE OBJECTIVES OF ECONOMIC POLICY

I propose to speak today about the objectives of economic policy. This is a subject which is both timely and timeless. Men have been concerned about the objectives of economic policy throughout history and throughout history there has been controversy about the relative importance of particular objectives as well as controversy about the means employed to attain them.

Back in biblical days Joseph was concerned about the objectives of economic policy. One of the great problems of the day stemmed from the recurrent waves of heavy crops and crop failures. To attain a reasonably stable supply of grain over the crop cycle of feast and famine Joseph built warehouses to store surpluses from the good years to meet the needs of the bad years. His efforts mitigated the distress occasioned by famine and thus advanced human well being, the ultimate purpose of an economic system.

At the time of our Declaration of Independence the great Scotch economist, Adam Smith, was concerned about the conditions needed for economic growth. He saw this as the major objective of economic policy saying that, as production "bears a greater or smaller proportion to the number of those who are to consume it, the nation will be better or worse supplied with all the necessaries and conveniences for which it has occasion". He concluded that the best way to attain growth was to avoid government or other interference in economic affairs. This is the famous doctrine of "laissez faire" or "let alone". Another English economist, Thomas Malthus, was concerned with the possibility that population growth would outrun growth in production of food. Still another, David Ricardo, was concerned with inflation and depreciation of the currency. And, more than one hundred years ago an English banker came to the conclusion that full employment and general prosperity required the Government to expand the currency.

The economic problems and the economic objectives that these men studied and wrote about are still being studied and written about today. At a particular time and under particular circumstances, one or another economic objective assumes greater or lesser importance. It is perhaps an understatement, for example, to say that the food shortage which bothered Malthus is not currently a matter of concern in our country. It is, however, a major problem in many areas of the world.

For many years after the Civil War, the problem of falling prices commanded a great deal of attention and prompted numerous proposals for the modification of our monetary system, many of these aimed at currency expansion so as to increase the money supply. Bryan's well known "Cross of Gold" speech in 1896 is perhaps the most famous exposition of the case for circulation inflation. And the decade beginning with World War I witnessed first a more than doubling of the price level followed by a violent collapse of prices. This experience was followed by considerable emphasis on the importance of price stability, a condition which prevailed, together with fairly general prosperity, in all but the early years of the twenties.

The thirties brought a new kind of economic problem which was destined to shift the emphasis of economic theory and to dominate public economic policies of the future. This was the problem of chronic unemployment. To be sure, unemployment had occurred before but it had not been of such great magnitude nor of such long duration as it was in the Great Depression. This was a particularly serious malady since, unlike gyrations of the price level, it <u>necessarily</u> brought our living standards - the volume of goods and services we could consume - well below the capacity of the economic system. The presence of unused resources in an environment of great want was a paradox, the explanation of which has occupied much of economic thought since the thirties.

At the close of World War II there was considerable fear that the cutback in war production and the demobilization of the armed forces would

lead to widespread unemployment. Hence the Employment Act of 1946 stated that the Federal Government should use all practicable means to aid in achieving maximum employment, production and purchasing power. The postwar inflation again brought the objective of price stability into prominence, but without reducing the importance of the objective of full employment. And with a rapidly increasing population it became evident that economic growth would be needed to permit absorption of the labor force into full employment.

Today, I believe it is a fair statement to say that most people would agree on three major objectives of economic policy: sustained growth in the economy so that living standards can rise; high employment so that total production and consumption can be as large as the size of our labor force permits; and stable prices to promote the best allocation of resources and to eliminate the arbitrary redistribution of wealth which accompanies violent changes in the price level. Controversy, however, centers around the question as to whether all three of these objectives are attainable at the same time and, if they are not, which are the more important objectives. This question is of particular importance to bankers and especially to the Federal Reserve. It is often stated that the primary purpose of the Federal Reserve is to influence the supply, cost and availability of money and credit with a view to promoting high employment, stable prices and a rising standard of living. This is, of course, merely a little different phrasing of the three economic policy objectives noted above.

I turn now to consideration of the compatibility of the three objectives. Much has been written in recent years about the incompatibility of the objectives of growth, high employment and price stability. The point most often made is that growth and high employment are compatible but that price stability is not compatible with either. It is asserted either that rising prices are inescapable if there is to be growth and high employment, or that rising prices are necessary to attain maximum growth and employment.

In either case, it is asserted, long-run inflation is inevitable if our output potential is to be realized, although it might be hoped that prices would only creep up. Important weight is given to the fact that we had great growth and full employment during most of the postwar period even though we also had a strong upward price movement.

To my mind a far more persuasive case can be made for the interdependence of the three objectives, a case based on both logic and history. Without reasonably full use of resources, both human and material, we encounter economic waste and therefore we attain something less than full-scale growth. This is pure arithmetic. Without reasonable price stability, we add to the uncertainty of business decisions, to speculation, and to questions about the desirability of saving. All of these tend to bring less efficient use of resources and sharp swings in the volume of investment and thus do not contribute to balanced growth. This is pure history. And, to bring the argument full circle, without reasonably steady economic growth we fail to attain the best full-scale use of resources. This is arithmetic again.

Neither the American economy, nor any other, is perfect and consequently we do not attain all objectives of economic policy at all times. This is no real reason to abandon any of them. It is a fact that we had growth with price inflation during the past decade, of course, but this proves no more than that we had both growth and inflation at the same time. It does not prove that the two are inseparable, nor in my judgment that this situation is desirable. I believe that an important conclusion to be drawn from the record of the postwar period is that we would have had less misapplication of capital investment and consequently less trouble at the present had we been able to contain prices better.

One further point deserves mention in connection with the objectives. One lesson which economic history would seem to teach us is that total growth and gains in productivity tend to come in surges, rather than as a smooth

upward sweep. A free economy cannot operate perpetually at full capacity. Among various reasons for this are adjustments necessitated by changing tastes of consumers, changing technology and mistakes of judgment which incidentally are made not only by capitalists but by commissars too. It is as though the economy must digest, catch its breath, and rest from time to time. The real problem is to see that the breath-catching or resting phase does not get to be an uninterrupted habit.

Since the physical volume of goods and services produced depends upon the levels of employment and productivity, which in turn depend upon investment, technology and labor quality, it is not likely that aggregate output will always grow at a steady pace. Even with unemployment at low levels, growth will be affected by changes in the number of people who wish to work and by erratic success in finding better ways to produce. The presence of short plateaus or even occasional mild dips in the gross national product is not inconsistent with the objective of economic growth, particularly in a market economy where productive resources must constantly shift to accommodate the changing preferences of buyers. Economic policies designed to prevent any departure, no matter how small, from persistent growth in the output statistics may create more damage than good.

By the same token, price stability as a goal does not call for price rigidity. Changes in buyers' wants will bring about some price changes. Price advances may be needed to accommodate significant changes in consumer tastes. In contrast, increasing productivity may call for price declines because goods can be produced more cheaply. In particular, I wish to emphasize that it is desirable that prices be <u>individually</u> flexible. If our economic system is to function adequately in allocating resources, prices of individual products must be reasonably free to rise or fall depending on the market situation. Neither should we expect that the general level of prices can or will be held rigid. What it is imperative that we avoid is a persistent, cumulative change such as has occurred in the past fifteen years.

To summarize, unless we use our productive capacity, we waste it and as a result we fail to obtain our potential standard of living. Unless we protect the value of our money, we promote inefficiency and contribute in an important way to an off-again-on-again rate of growth that also falls short of our potential.

Now let me turn to a brief review of the postwar economic record. We came out of World War II with a very high level of liquid assets in the hands of individuals and a relatively low level of private debt. Continued high employment produced high current income. All of these factors made effective a high level of current demand which was reinforced by the heavy volume of demand deferred during the war years and the depression years before the war. Goods could not be produced fast enough to satisfy this demand and we had a strong price increase - mostly due to the effects of the war.

In 1949 and early 1950 we had a dip, mostly an inventory adjustment which was brought on mainly by the previous scramble for goods at rising prices. We took that in stride and were coming out of the mild downturn when the Korean War added another major factor of economic demand, setting off another sharp but short-lived price increase. From 1951 through 1953 we had reasonable price stability with rising employment and steady economic growth.

Cuts in defense spending plus some inventory adjustment brought another, milder, dip in 1953-1954. We came out of that with a bang as a result of the big capital investment boom and the sharp increase in housing and automobile demand. Again, however, prices stayed reasonably stable until mid-1956, at which time they began to show substantial strength as demand began to press upon capacity to produce.

In 1957 the economy moved mainly sidewise until autumn. Its course then turned downward and we entered the current recession. And in connection with this recession let me make a few pertinent points which have considerable bearing on the course of monetary policy during 1957.

The dollar value of the nation's output was growing at an increasing rate during the first half of 1957, partly because prices were rising; this served to intensify the already serious inflationary psychology pervading the land. Although capital investment, the key factor in the boom, was lower in I quarter 1957 than in I quarter 1956, in the next two quarters it increased and was higher than a year earlier. Industrial production dropped slightly in the early part of 1957 but then moved up again and in September was higher than in April. Not until October did it turn down appreciably. In October, unemployment was lower than in January or February and had fallen steadily throughout the summer and early fall. Not until November did it show a significant increase. Prices, both wholesale and retail, showed strength throughout the year, and, in fact, are still rising.

These are all physical or dollar value measures and might be said to constitute part of the statistical record. But on top of these, the rise in stock prices was saying that investors foresaw further inflation and the rise in interest rates testified to a tremendous demand for credit.

Current conditions and sentiment through early fall indicated a strong inflationary movement backed up by a strong psychological belief that it might well continue. As a result, monetary policy was restrictive until about mid-October, 1957. It reached its high point in the discount rate advance in August. After mid-October, as the current signs began to show that the breakout from the sidewise movement was downward, monetary policy eased and became easier as the downturn continued. The discount rate has been reduced from 3 1/2 percent to 1 3/4 percent, in several steps. Reserve requirements have been reduced in three steps. And Open Market policy has aimed at providing additional reserves to the commercial banking system.

The net result of these credit easing actions has been a phenomenal expansion in bank investments and in total bank credit, a very striking drop in capital market, money market and loan interest rates, a very sharp gain

in bank and corporate liquidity, and the bringing forth of a considerable volume of borrowing in the capital markets. The total money supply has increased and the increase has come at a time when, even in an upswing in activity, it is normal to see a seasonal contraction.

Let me put in a few figures to illustrate these developments. Between September and May, member bank borrowings at Reserve Banks declined from about $1 billion to little more than $100 million. Excess reserves have increased and thus member banks have shifted from a net borrowed reserve position of about $500 million to a free reserve position of about $500 million.

The shift in net reserve positions by more than $1 billion does not tell the whole story. The point to be noted is that in maintaining a free reserve position while member banks are expanding their assets and deposits, the System has been pursuing an active policy. As banks have utilized the reserves provided by System operations, additional reserves have been made available.

That the banks have been using the reserves made available by the System is indicated by the fact that commercial bank loans and investments increased more than $8 billion in the seven months from the end of September 1957 to the end of April. In the same period a year earlier, bank credit had increased only $3 billion.

The growth in bank credit has been mainly in the form of United States Government and other securities, and this has contributed significantly to an easing in the money and capital markets. Bank loans to businesses and consumers have declined with economic activity. On the other hand, mortgage holdings of banks have increased somewhat and loans on securities, which provide important support to the capital markets, have also risen.

The substantial increase in commercial bank credit in the period since last fall has been reflected on the deposit side primarily in a record growth in time and savings deposits. The active money supply, as represented

by demand deposits and currency, has increased about $1 1/2 billion or 1 percent since September. But time deposits at commercial banks have gone up almost $5 billion or 9 percent as depositors have elected to transfer demand deposits to time accounts. Whether in time or demand form, the growth of bank deposits is serving to increase the liquidity of the economy and thus to provide the financial basis for renewed economic growth.

The transition from restraint to ease in monetary policy has produced a marked reaction in financial markets. Short term interest rates have fallen sharply. For example, the rate on Treasury bills, an indicator of the availability of funds in the money market, has declined from over 3 1/2 percent in October to less than 3/4 percent recently.

Longer term market yields have come down about 3/4 of a percentage point from their peaks last autumn. But there has been a heavy volume of security flotations in these markets - and this, of course, is the desired objective of lowered interest rates. State and local governments, which in some cases postponed borrowings during the period of monetary restraint, have borrowed 30 percent more in the capital market this year than in the first five months of 1957. Corporate borrowing has so far been only slightly below the record volume of 1957. Foreign borrowers and international institutions have also borrowed more heavily in the United States capital market than last year.

Thus monetary policy has contributed to an increase in the availability and a reduction in the cost of borrowed funds. Commercial banks have reduced their lending rates and, with their reserve positions eased, they are in a condition to respond to increased loan demands. Meanwhile, their security purchases have provided a large flow of funds to the money and capital markets, thereby facilitating private and governmental borrowing in those markets.

At some times, the proper course of public policy is more clearly visible than at other times. Currently, for example, most of the signs indicate that economic activity has already declined by more than in the recessions of

1949 and 1954. This fact lends powerful support to public policies aimed at stimulating the demand for goods and services and thereby creating jobs. It does not argue, however, that we should forsake completely the other objectives of economic policy, nor does it argue for unsound methods of attaining our goal of higher employment.

Now, to conclude this talk I come back again to the question of economic objectives against a background of action and change. At the moment we want higher employment than we have and we want a resumption of growth. Thus we emphasize policies that will help attain these conditions. At the moment, while prices are still rising, they reflect more seasonal movements than real strength so we need not emphasize this goal as strongly as we did in mid-1957. But it is still an objective to have price stability and in time it may well be the paramount objective again.