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THE ASSETS OF CREDIT POLICY

The title of this talk was chosen deliberately. I want to present to you this morning the positive case for using monetary or credit policy - and the terms are interchangeable as I am using them - as an economic stabilization device. Notice that I said "an economic stabilization device" rather than "the stabilization device". I believe that a lot of the confusion that seems to exist about credit policy stems from simple confusion of "the" and "an".

In developing this talk you will find that I am discussing past and current economic history, economic growth, interest rates, foreign trade and gold movements. Only against this kind of background does discussion of credit policy make much sense.

Let me first describe briefly what monetary policy is, what it does and how it does it. Monetary policy deals primarily with the supply, cost and availability of bank reserves. By varying either the amount of reserves or the legally required ratio of reserves to deposits, monetary policy influences the supply, cost and availability of credit, the amount of the active money supply and the capital values of financial assets. These in turn influence the amount of spending and saving and the direction of spending and saving in the economy.

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I do not propose here to go into the technicalities of specific monetary policy tools such as reserve requirements, open market operations, discounting, margin requirements, etc. The only point I want to stress here is that monetary policy works on and influences the reserve base of the banking system and in so doing affects spending and saving.

The second point I want to make is that monetary policy formulation is not an exact science. In point of fact it is more art or craft than science. Let me try to illustrate and explain why this is so and in so doing I will talk about interest rates or the cost of credit.

There are a number of theories of interest rate determination which center in different, though not necessarily mutually exclusive, aspects of the process through which interest rates are set. Thus some stress the saving-investment process, some stress cash balances and liquidity demands, some stress supply and demand for loanable funds. The point I want to stress is that elements of all of these theories account for interest rate movements, as observed by a central banker, at particular circumstances of time and place and under particular institutional characteristics of the economy. Consequently monetary policy cannot be based on one well-defined and articulated theory - or at least it cannot be so based given the present state of knowledge. It simply has to be more pragmatic.

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This fact, however, makes it neither unique, mysterious, or ineffective. A lot of public policies have to be determined without perfect theoretical bases. And the fact that precise determination of the effects of credit cost versus credit availability, of changes in the money supply versus changes in liquidity and velocity is not possible at this time, should not be taken to mean that the general linkage between monetary policy action and economic response is impossible to discern. Questions of how much and how fast should reserves be varied have to be answered in the light of associated factors of liquidity, velocity and so on, but they can be answered reasonably well at a particular point in time - they merely are not susceptible of formula treatment. And what that means in practice for a central banker is three things. There is no substitute for accurate information and lots of it, no substitute for hard thought and analysis and lots of it, and no substitute for a healthy respect for a moderate approach to policy. What I am saying, of course, is that monetary policy formulation and execution is a job that requires day to day, even hour to hour, attention. There is nothing particularly unique or mysterious about that either.

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The third point I want to make has to do with the general effectiveness of monetary policy. I am struck particularly and almost continuously by the fact that a lot of the controversy over monetary policy apparently originates in forgetting, overlooking, failing to appreciate, or simply not recognizing some very obvious factors.

A. Monetary policy is not an all-powerful economic stabilization weapon which, in proper hands and properly used, can eliminate the business cycle, produce a satisfactory rate of economic growth, keep unemployment to a fictional minimum and stabilize the general price level. No central banker that I know believes or advances this point. And yet a substantial body of criticism directed at monetary policy seems to be rooted in the proposition that any deviations in prices, increases in unemployment, slowing down of growth or level of activity are direct consequences of the failure of monetary policy to be carried out properly.

My colleague at Atlanta, Malcolm Bryan, once used a graphic analogy to make this point by comparing monetary policy with a wife who was beautiful, a good cook, a brilliant conversationalist, a fine mother and a talented pianist, but who was sued for divorce because she was physically unable to move the piano.

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Without laboring this point further, I should say that I know that not everybody bases criticism of monetary policy on this approach. In fact, another substantial body of criticism seems to be rooted in a reverse proposition.

B. Monetary policy, in its present form, is of some consequence. The fact that prices rose substantially following World War II and edged up even after the Korean War impact was spent, that we had three dips in economic activity since World War II, that unemployment currently hovers just below 5 per cent, and that we did not match the Russian growth rate in the late 1950's, are cited as proof that monetary policy is impotent. In point of fact, the record since 1951 has been pretty good taken as a whole, as I shall try to demonstrate later.

Actually, of course, monetary policy is neither impotent nor all potent. It is an important stabilization device; it works best when other stabilization devices are used more fully than they have been over much of the postwar period.

And in this connection I want to underline a point that has been cited often but seems to be disregarded even more often. The record of history and, most strikingly, the record of recent history abroad would seem to demonstrate almost beyond challenge that sound, courageous, and well-timed monetary policy action, coupled with similar fiscal policy action, can and has contributed

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to high rates of real growth with reasonable price stability. Foreigners seem to be far less doubtful of the usefulness of monetary policy than we.

Now to recap briefly. Monetary policy works on bank reserves and through them the supply, cost and availability of credit, the money supply and the liquidity of the economy. These influence spending and saving. Monetary policy is not an exact science; it is a day to day task - an art or craft. It is important but it is not a panacea for all economic aches and pains.

At this point I want to emphasize what I believe to be the most important asset of monetary policy in our kind of economy. It is a general or overall stabilization device. It does not attempt to usurp the functions of a free market economy. It sets the broad credit climate but within that setting the economy is free to move, to allocate resources to the most productive uses.

General monetary policy does have selective impact on the economy. This point seems to have been discovered fairly recently by a number of people who reason from it in two ways: (a) since this is so, why not use a battery of selective controls in place of general monetary policy and/or (b) the uneven impact of general monetary policy has social, economic, and political costs it would be well to avoid by using some other device or devices to

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accomplish the same general purpose.

It is obvious that general monetary policy has selective impact on the economy. It is supposed to have. In theory, the individuals, businesses or sectors that find restrictive action adverse are those which are marginal performers. In a situation requiring economy of resource use, it is for the benefit of the economy as a whole to have resources go to more rather than to less efficient users.

The real questions here are whether the market mechanism does a better economic allocation job than would a non-market device and/or whether the social and political costs of the market allocation are too great to permit it to work. On the first point I have considerable doubt as to my virtues as an allocater as against the market mechanism under relatively normal conditions. On the second point, the question of social and political costs usually resolves itself into one concerning undue discrimination against various segments of the economy. I find the evidence of unfair discrimination against the three most cited sectors - small business, state and local governments, and residential construction singularly unconvincing.

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With these points out of the way I propose to devote the balance of this talk to the broad economic picture with particular emphasis on growth, interest rates and our gold supply.

Let me go back about 15 years to begin just after the end of World War II. As we tried to unwind from the physical and financial problems of World War II, interrupted by the Korean War, the United States economy moved from a wartime to a peacetime base, from an economy of civilian scarcity to one of abundance, from a controlled to a free market system. From early 1951 on monetary policy and the money markets have become more free and more flexible. On the record, economic activity has been high and average performance has been good. We had a dip in 1953-54 and again in 1957-58, but recovery was rapid in most instances. I believe it is more than a coincidence that this relatively good economic behavior and the presence of a flexible monetary policy occurred together.

By and large the major task of monetary policy during most of the post World War II period was to lean against an inflationary wind. That task called for a policy of restriction. But at times, as noted, economic activity flattened out or declined. In such circumstances more monetary ease was indicated. This is a flexible monetary pobicy approach and it seems to have worked reasonably well.

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Currently we face a situation somewhat different from any other in the postwar period. The year 1960 opened with some magnificent overstatements as to what economic activity would be this year. Since the results have not matched the overstatements a lot of people have been disappointed.

I want to make three points about the current level of activity. In the first place it really is not off significantly from what the more reasoned forecasts made at year's beginning stated. Probably the gross national product this year will average out $20 to $25 billion more than in 1959 - up 4 or 5 per cent in money terms, up 3 or 4 per cent in physical terms. That is fairly good. Second, this has been achieved while the economy was undergoing two massive readjustments: (a) liquidation of inflationary expectations which seems to have been primarily responsible for the drop off in inventory accumulation and (b) the tremendous swing from a federal budget deficit of $12 billion to a surplus of perhaps $3 billion. We actually are consuming more than we are producing at present; we are living in part off of inventory. In the past this has led to downturn; this time it has led at most to some drop in upturn. Third, the very facts that fear of inflation has abated and that the government is running a surplus permitted monetary policy to ease off - which it did early this year. Bank reserves have increased, the money supply has grown, and interest rates have come down.

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This brief review of current developments leads me naturally into the subjects of interest rates and gold movements and these in turn into the question of economic growth.

I said earlier that there are various theories that account for interest rates but no one theory that seems to fit all of the facts all of the time. This much may be said, however. Interest rates are a reflection of the interplay of demand and supply forces in the saving-investment process and they serve to equate demand for and supply of savings. They also serve to channel savings into more investment or into different types of investment or into more consumption. Finally, while the level of income is a most important factor in determining the amount of saving, this amount of saving also is influenced by the rate of return - the interest rate.

Thus, interest rates are important. They are so important, in fact, that monetary policy does not attempt to fix any given level of rates but prefers to leave that function to the market. Now monetary policy obviously can influence rates. If the central bank moves to add to reserves and thereby permits an increase in "created" money it obviously adds to the supply of funds seeking investment. If demand for such funds stays constant, interest rates will tend to decline.

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Now saving is of the greatest importance to economic growth. It finances investment which adds to productive capacity which permits and promotes economic growth. Without saving there can be no investment and without investment there can be no growth. So the trick is to keep, over the long pull, the supply of real savings in balance with the demand for real investment. These must match if we have high employment and a growing economy operating at about its capacity. This is true because economic resources are scarce and in a capacity operation resources going for investment have to be taken from consumption and saving represents the withholding of spending from consumption.

It follows then that "created" money can be no more than a relatively short-run substitute for savings in financing investment. It can bridge temporarily gaps between the flow of current savings and needed investment when real resources are available because the economy is operating below capacity. Created money cannot substitute for real savings in the long run because money is not a substitute for real resources. And thus no central bank can forever correct basic imbalances between supply and demand for real resources by creating money. That action merely drives up prices. No central bank can forever hold down interest rates for rising prices create greater demand for money and thus put pressure on interest rates.

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There has been a lot of comment in recent years to the effect that low interest rates are good and high interest rates are bad. I find it difficult to judge interest rates in this fashion. What we want, in fact what we have to achieve, is an interest rate structure low enough to stimulate investment, high enough to serve the economic purpose of allocating funds, under varying economic conditions, to uses which will best promote the welfare and strength of the nation. Thus there is no given level of rates that is either good or bad in all instances; at times high rates are proper, at times low rates are proper.

Interest rates at present are considerably lower than they were a year ago or even nine months ago. And the fact that they are lower and that monetary policy has eased has raised another kind of question concerning such policy. For with rates down some short term funds have flowed out of the United States to seek higher rates elsewhere and this has caused resumption of our gold loss. Some people have argued that an easier credit policy cannot be followed in the United States, no matter what the domestic situation, because we cannot afford to lose more gold.

The United States went off the gold standard more than a quarter century ago. We stayed on an international gold standard, that is we continued to settle foreign claims on us in gold, and we continued to back our

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currency with a gold reserve. For a number of years gold flowed into this country; in the late 1930's it flowed in so rapidly it embarrassed us. Then it began to flow out in the 1950's.

Just what are the facts about our gold position. We have today about $19 billion of gold, about half of the world's (outside Russia) gold supply. Short term claims on us by foreigners are about as big as our gold supply. Theoretically if all these dollar claims were changed into gold we could lose all of our gold. Practically, of course, these claims will not be exercised anymore than all of your depositors' claims on you will be exercised at once. Someone observed recently that the United States had not yet even begun to have to act like a world banker. Our short term liabilities are still fully covered by gold. Other nations have gold reserves against their liabilities that are far smaller relatively than ours. If we are in dangerous shape the rest of the world is broke and has been for years.

But there is some point to this concern over gold. It lies in the fact that we have been losing gold for a decade and we have lost it mainly because our balance of payments has been out of balance. The balance of payments is merely a technical term describing the net difference between all of our out payments and all of our in payments. Out payments include payments for imports, short and long term capital flows out, payments for our overseas

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military establishments and foreign aid. In payments include payments to us for our exports, earnings on our foreign investments, short and long term capital flows in. In 1958 our net balance was a minus $3.5 billion; in 1959 it was $3.9 billion; in 1960 it may be as much as $3 billion. Why is this?

It is because our out payments have been bigger than our in payments. We are the biggest exporting nation in the world and we export more goods and services than we import - about $4 billion more at current rates. But this difference is not big enough to offset net capital outflows plus military spending abroad plus foreign aid. Can we cut foreign aid and balance? Well it would not help much since most foreign aid money is spent here so it would cut our exports almost as much as foreign aid is cut. Anyway it would not be wise to cut aid under present conditions. How about military spending abroad? This would help the balance of payments but might well destroy the balance of power. Capital flows? American business finds it profitable to invest abroad. Well what is left? Build up our exports of goods and services which means get more competitive. And that brings me right back to monetary policy.

We won't get more competitive by taking steps to inhibit saving and thus investment. We won't get more competitive by a too easy money policy that brings about price rises here and makes this a bad market to buy in. So it is imperative that we follow policies that will help keep us competitive.

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But can we really follow an easier money policy here if short term funds flow out in response to higher rates abroad. Yes we can, because we can afford to lose some more gold - especially if a rate turn around in the future will bring it back. These funds move regularly and we must be prepared to handle such movements. In total they represent probably about 10 per cent of our total gold stock.

What we cannot do, however, is follow policies which will lead to loss of confidence in the dollar. So far that has not occurred and I do not believe it will occur - at least if we are sensible. If confidence were lost then gold would flow out very fast and then we would be in trouble. But as foreigners watch us and see us following sound money and tax policies they will not lose confidence.

In summary then, we have lost gold. We can afford to lose what we have and even more. But we cannot afford to lose gold forever. And what we need to do is get more competitive, sell more abroad and follow policies that lead to confidence in stability of the dollar. This is the kind of job good monetary policy is supposed to do.

Now one last word about economic growth. We have had great growth in this country. We stand at the very pinn cle of success in this field. We have achieved this because we have invested heavily and we ha v e been able to

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do so because we have saved substantially. We need to continue to save, to invest and to grow. The way to do this is to preserve a stable currency. This is our big asset and it is this asset that credit policy is designed to nurture.

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