Federal Reserve Bank of New York Addresses and Speeches Sproul

REMARKS OF ALLAN SPROUL, PRESIDENT,
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I suppose if I had as much sense as recent obituary notices have indicated I possess, I would confine myself on this occasion to expressing the pleasure of the Federal Reserve Banks of Philadelphia and New York in having you as guests at this luncheon. The pleasure is real, but perhaps the luncheon should be leavened with some talk about Federal Reserve matters, so that those who scrutinize our expenditures for such things as bankers' luncheons will not think we have been wasting our money. In any case, I am an incorrigible talker about the Federal Reserve System and, even at this late date in my career, I find it impossible to resist the lure of an audience which may be receptive to some plain talk about credit policy and about the financial arrangements through which it seeks its objectives.

Recently the Federal Reserve System has been criticized because of its continued policy of credit restraint, emphasized during April by an increase in the discount rates of the Federal Reserve Banks. This is no surprise. Criticism is the normal lot of a central bank or a central banking system. Nevertheless I would like to comment on some of this criticism.

Let me make it clear, right at the beginning, that I have no quarrel with those in high or low places who have said that they would not have increased discount rates in April. It is always possible, as in this case, for reasonable men working with the same set of facts to come to different conclusions in the still imprecise field of economic analysis. This is particularly so when the economy is moving along a high plateau, and when there is no clearly apparent and dominating force which is likely to cause it to resume its upward journey or to send it down into one of the valleys of recession that lie along the way. Our more exact measures of economic progress relate to the past, and even they are subject to inbred errors which are greater than their recent minor moves in either direction. Our glimpses into the future are still those of men with imperfect foresight and with imperfect knowledge of how millions of human beings will react to various economic stimuli and deterrents.

For my own part, in trying to assess the existing situation and to pierce the haze which conceals the exact course of the road ahead, I would say we had to look closely at the behavior of prices, of the capital markets, and of bank credit, recognizing that in the whole range of economic forces which determine the level and trend of employment and production, these are but three factors, albeit important ones. Certainly they are factors which are close to the responsibilities of the Federal Reserve System. It must always be repeated and remembered that the monetary authorities are not economic dictators, for which we can all be thankful. If they do their job well, and if the fiscal authorities and other branches of Government do their jobs well, and if management and labor conduct themselves with some degree of economic intelligence or

enlightened self interest, and if the consumer exercises his sovereign rights with some degree of steadiness, we can hope to achieve sustainable economic growth. But the Federal Reserve System can only contribute to or subtract from the overall result.

In the area of prices, capital markets, and bank credit, to which I have directed particular attention some things seem reasonably clear. Despite the generally level trend of broad measures of aggregate production, income and employment during recent months, wholesale prices generally and industrial prices particularly have moved up appreciably. There have been some sharp downward movements within the whole complex of prices, but the predominant trend of prices has been upward for the past year or longer. This may have reflected strains upon existing capacity in some instances, and the upward push of costs on prices in others, but it was not something to be facilitated and encouraged by too easy access to reserve funds at too little cost. In time, rising productivity, expanding capacity, and keen competition should bring their own relief from such a situation but, in the short run, here was a pressure to be resisted.

In the capital markets there has been recurring evidence of a tendency for capital demands to outrun the currently available supply of savings, with consequent temporary congestion and some seepage of bank credit into capital uses. We have been in transition from a period in which consumer investment in houses and durable consumer goods was the dominant expansive force in the economy to a period in which business investment in plant and equipment is the dominant force. Such periods of transition, which are natural in a dynamic economy free of most central planning, are likely to be periods of delicate balance. If the changeover takes place gradually and smoothly, the economy prepares itself for new growth without too much loss of momentum. If the changeover takes place abruptly and roughly, a downward movement may begin which feeds on itself for a time. Thus far we seem to have escaped this danger. Aggregate production and employment have continued at high levels, and fright and fear have not spread out from centers of temporary curtailment of production and employment to chill consumer demand. For the continuance of this model changeover it is most important that the capital markets continue to function properly, and it is not without significance, perhaps, that since the increase in discount rates at the Federal Reserve Banks these markets, which prior to the increases were nervous and uncertain, seem to have found a new trading base which is more to their liking. This has presumably involved some screening out of less necessitous projects, but that was inherent in a situation in which plans and projects were outrunning capacity in the capital goods industries.

When it comes to bank credit, it is hard to find evidence of too great restraint on business borrowing. The use of bank credit by business has been larger during the present year than can easily be explained by a business situation which, in the aggregate, has been moving sidewise except possibly in terms of inventory accumulation and reduced business liquidity. After a less than seasonal decline in business loans during the first two months of the year, there was a sharp upward thrust in March, which has since been confirmed, and the prospective demands of coming weeks, which include the June 15th tax payment date, are heavy. There has been no shying away by the Federal Reserve System from its responsibility to supply the reserve funds needed to meet necessary demands for

bank credit, whether temporary or continuing. And I would expect that there would be no shying away from that responsibility in the future, whether over the next month or later when seasonal needs for credit are supposed to make their appearance. But with this responsibility goes the equal responsibility of trying to see to it that bank reserves are not so readily and cheaply available as to foster and promote expansive efforts which are temporarily beyond our physical capacity for balanced growth. It seemed to me at least that, rather than run this risk, it would be better to give public notice, by way of an increase in the discount rate, of the pressure being exerted on the commercial banking system by business demands for credit. In this way the banks would be further encouraged to make adjustments within their own loan and investment portfolios to meet these credit needs, and to screen more carefully the necessary demands for credit from the speculative or fringe demands.

There are those who would discard or discount the evidence of the figures of bank credit if it does not jibe with certain formulae concerning the optimum relationship between the "money supply" and the growth of the economy. They are inclined to believe that the money supply has been lagging during the past year or more in which the Federal Reserve System has been following a policy of credit restraint, and that this may be slowly strangling business. I must confess that I have little confidence in these mechanical formulae. I think this one, to the extent that it is applicable, is only applicable over long periods of time. It produces pretty effective charts of the past fifty years, but doesn't tell you much about the next fifty days or even weeks. There are inherent difficulties in defining the "money supply", in measuring it, and in allowing for its changing distribution and for the changing intensity of its use, which rob it of much of its short term validity as a guide to credit policy. It cannot be disregarded as a component of our economic well being, but it is only one factor in the complex of monetary and credit phenomena which must be viewed together.

Quite apart from the differences which can arise and have arisen recently in the interpretation of economic signs and their meaning for credit policy, are the attacks which have been made on credit policy from two widely different sources. On the one hand we have had big business blaming credit policy for what it would term unnecessary declines in the production and sales of consumer durable goods. And on the other hand we have had those who claim to speak for "small business" charging that too much of the credit pressure which monetary policy has helped to create is falling on those least able to bear it, and that it is therefore inimical to American concepts and social progress.

To be specific in the one case, it has recently been claimed that the difficulties which have beset the automobile business are due in large part to the credit restraint policy of the Federal Reserve System. There can be no argument that the difficulties of the automobile business, with its ramifications throughout the economy, are of the greatest importance. I would say that some of us have been concerned for the past year about the possibility of such difficulties. But to ascribe these difficulties to a policy of credit restraint is a sort of cosmic jest. Rather, it seems to me, that so far as credit is involved, the difficulties have arisen out of a misuse, or abuse, of one form of credit during the lush days of 1955, and that we are paying for it in 1956.

I do not want to be misunderstood. I appreciate the great utility of consumer instalment credit for large numbers of people; and I recognize its great contributions to the development of some of our mass production and mass consumption industries. But it can be misused individually and in the mass. The present situation in the automobile industry seems to me to support the belief that a too rapid growth of consumer instalment credit, stimulated by relaxation of payment terms, can accentuate swings in production, consumption, and employment. The rapidity of last year's increase in this easy approach to record sales volume has come home to roost. We must hope that the rest of the economy will maintain its vigor and strength until this error in calculations has been corrected. Fortunately the economy has thus far given evidence of being able to do so, although a sterner test may be in the making.

The questions which have been raised in behalf of "small business" about a policy of credit restraint are more difficult. Although I doubt if categorical proof can be produced, I suspect that the impact of a policy of credit restraint is greater on "small business" than on big business. This suspicion does not arise from reading reports of sample surveys, unexplained as to detailed method and techniques, but dressed up in the garments of scientific inquiry and statistical accuracy. I think that such reports hold a dubious place in economic analysis. On broader grounds, however, it seems fairly clear that "small business" has less access to alternative sources of funds when bank credit is not readily available and only less clear that its access to bank credit is likely to be more difficult under such circumstances. Access to bank credit is achieved primarily by reason of the credit worthiness of the borrower, long established customer relationships with the lender, and the profitability of the transaction. It may well be that big business has an edge in these respects, which becomes apparent when not everyone can get all of the credit that everyone wants.

If this be so, however, it is only one aspect of our economic organization in which bigness has certain advantages not confined to access to bank credit. The social and political implications of this problem have troubled this country for a long time, and need some new thinking based less on emotional and inherited dislike of bigness than has been the case in the past. The Federal Reserve System, the instrument chartered by the Federal government to exercise general credit control, should not be blamed for discharging its responsibility, even though it may seem at times to add to this problem. That responsibility has to do with the total supply of credit in relation to the needs of a growing economy, and with the preservation of stability in the purchasing power of the dollar. It does not reach through the commercial banking system to the ultimate users of credit, trying to say how much shall go to "small business" and how much to "big business". The allocation of credit to its final uses has been left to the private banking system, dealing directly through thousands of banks with millions of customers. It would take a great deal more "planning" and more "direction from above" than the country has heretofore tolerated to change this situation. As of now, we can only hope and expect that the size of a business will not be a major deterrent to obtaining necessary credit if the other ingredients of a good loan are present.

What may be happening is that only within the past few months, or weeks, the majority of smaller or so-called "country" banks have come to feel the full force of the general credit restraint that has been pressing on the larger banks,

and the customers of those banks, for some time. If this be so, thousands of potential borrowers are probably feeling that "something new has been added" to their troubles, and the consequence is greatly increased public and political awareness of the working of a policy of credit restraint.

Aside from these natural and critical reactions to a restrictive credit policy, there are some paradoxes in the situation which have now come to the fore. Many big banks, through their branch systems, are engaged in small business. Big business and small business are here intimately related, and it is not the kind of relationship which can be cut off or resumed with each change in the economic wind. Credit worthiness, established customer relationships, and profitability continue to outweigh smallness or bigness in the allocation of available credit. Looked at in another way, banking is a small business in terms of the numerical majority of banking institutions. The thousands of small banks which dot the country cannot be charged directly with favoring big business in preference to small business in times of credit restriction. What is more likely is that during periods of credit ease, when many of the larger banks were building up their secondary reserves by buying Government securities, including a substantial proportion of short term securities, many of the smaller banks were reaching for the higher yields on mortgages and long term securities. With the great increase in the demand for business loans during the past year, the larger banks have obtained substantial funds with which to accommodate their customers by a massive reduction in their secondary reserves. Many small banks may have found this more difficult and less profitable, because of the larger losses entailed in liquidating long term securities in declining markets, and because of the smaller spread between yields on such securities and the yield on new loans.

I put this forward as an hypothesis which needs examination if we are going to look more fully into the question of the impact of a policy of credit restraint on small business. It would lead us into many fields of inquiry, such as to what extent the small independent bank is a bulwark of the American system of individual initiative and competitive enterprise, and to what extent our independent banking system may shield a considerable number of local monopolies. I must admit that I am intrigued by such questions.

I hope others are more than intrigued. It is time we knew more about our whole financial apparatus. A broad national inquiry seems to me to be necessary. I do not have in mind such piece-meal inquiries as those concerning the Federal Reserve System and the Federal Open Market Committee which have marked the past few years, but an inquiry into the whole intricate and complicated arrangement of financing institutions which has developed during the past forty years and particularly during the latter half of that period. This would be an inquiry to map the terrain rather than one to lead to specific legislative action. Without such a map, legislative action in specific areas may be confused and, at times, self defeating.

To serve such a purpose, I should think a Presidential commission of somewhat the same general character as the so-called Randall Commission, which studied our foreign economic policies, would be a useful device. When it had completed its work, Congressional attention could be given to particular areas in which legislative action might improve the functioning of our money economy. We cannot afford much longer - or we can only afford it because we are rich - to go ahead not really knowing what to expect of our central banking system, of our commercial banking system, of our savings banks and building and loan associations, of our insurance companies and pension trusts, and of all the other bits and pieces which we are using to try to keep our production facilities and our credit facilities in balance. The task would be a difficult one. The rewards could be commensurate with the difficulties.