FOR RELEASE ON DELIVERY:
(Approximately 11:00 a.m., EDT,
Wednesday, May 6, 1959.)

THE ROLE OF MONETARY POLICY IN A GROWING ECONOMY

By Karl R. Bopp
President, Federal Reserve Bank of Philadelphia

Annual Meeting
Health Insurance Association of America
Morning Session, Wednesday, May 6, 1959

Bellevue-Stratford Hotel, Philadelphia, Pa.

THE ROLE OF MONETARY POLICY IN A GROWING ECONOMY

By Karl R. Bopp

That economic growth is desirable few would deny. Without growth our increasing population would face rising unemployment and a declining standard of living. The growth record of the United States has been remarkably good. It has been growth — not our original endowment — that has provided the people of the United States with the highest standard of living in the world. Until recently, growth was taken for granted. It was not a specific objective of economic policy.

Interest in economic growth has been intensified by the recent announcement of Russia's progress and plans for the future and by the persistence of unemployment despite widespread recovery in business activity. The first is widely interpreted as a threat to our security. The second arouses our sympathy for those still unable to find jobs, and highlights the need for continued growth if we are to maintain reasonably full employment. Before going into the role of monetary policy, I want to make a few observations about growth and indicate some of the principal factors influencing it.

Growth in what sense?

What kind of growth do we want? We can easily increase the dollar value of goods and services by inflating the money supply and prices. But this does not give us more goods and services to enjoy. We can have more to consume only by producing a larger physical volume of goods and services. A rising standard of living requires a more rapid increase in output than in population to provide more goods and services per capita.

In seeking growth, we are surely concerned with more than merely increasing the aggregate of goods and services produced. We want the right mix -- the kinds and quantities of goods and services that people want. But this means that as wants change, labor and other resources need to be shifted from producing goods for which there is a decreasing demand to producing those for which there is growing demand. A growing economy in which the consumer is king is one of change. New products and services cause some industries to expand; obsolescence and shrinking demand cause others to decline.

As a final observation, we should consider economic growth not in isolation but in relation to the other things we want our economic system to provide. For example, do we want growth at the expense of freedom? A totalitarian state such as Russia can increase its rate of growth by diverting labor and other resources to the production of plant, machinery, and equipment. Capital equipment is increased at the expense of consumer goods. Its people are forced to save. Undoubtedly, such forced saving will accelerate their rate of growth, at least for a time. But I doubt that we would maintain the flexibility and incentives for efficiency needed to sustain a high rate of growth if we adopted a controlled and coerced system. Such a system may make a good showing in the hundred-yard dash but fare badly in the marathon. I, for one, believe we should seek growth within the framework of a free society.

<u>Major factors influencing growth</u>.

Economic growth is compounded of many ingredients. The rate of growth is influenced significantly by the character of the people and by the economic and social environment in which they live and work. Before attempting to appraise the contribution that monetary or other economic policies can make, we should first take a look at some of the fundamental forces influencing economic growth.

One that is often overlooked -- perhaps because it is so simple -- is the intensity of people's desire for material goods and services: homes, automobiles, clothing, refrigerators, education, a weekend at the shore, etc. An official of the central bank in West Germany, asked for an explanation of his country's remarkable economic progress in the postwar period, replied: "The answer is simple. The people wanted goods they had been deprived of for years and they were willing to work hard to get them." An intense desire for goods and services in this country has been a powerful force stimulating demand and in providing the resources necessary to produce them.

Research and technological advances have contributed much to our economic progress. Research is the source of new products and new and improved methods of production. In many of our newer industries, such as electronics, missiles, plastics and synthetic fibers, a large part of current sales consists of products not produced ten years ago. The productivity of labor has risen markedly mainly because of the inceasing quantity and improved quality of plant and machinery used in production.

Technological progress, however, requires an increasing volume of saving and investment. We must abstain from consuming all of our current output in order that a part of our productive resources may be employed in producing machinery and equipment. A relatively high rate of saving and investment is thus essential for sustained growth. This raises a basic question. As our material standard of living rises, how much current consumption should we forego in order that we and our children may have even more goods and services to consume in the future?

Mobility of resources is another factor influencing the rate of economic growth. As already mentioned, a growing economy is dynamic. Consumer wants are constantly changing, resulting in declining demand for some products and increasing demand for others. Technological innovations create a demand for new machines but render the old obsolete. The short-run effect may be reduced output, unemployment, and a loss on investments in the old and declining industries. There is need for more labor and more capital, however, to produce the products in greater demand and the improved machines which render older ones obsolete. The temporary losses suffered by workers and investors in declining industries are the price we pay for the privilege of buying the goods of our choice, and the long-run gains in productivity derived from improved machinery and technological advances. Unemployment compensation is a method of having society, which gains, bear part of the costs of those displaced, who lose in the process. Short-run losses are less and gains are greater the more promptly labor and capital are shifted from declining to growing industries.

Progress requires mobility, but a desire for security inspires efforts to maintain the status quo. To protect investments and jobs, those adversely affected by changing wants and technological advances may resist the introduction of new machines and improved technology. Often they appeal to government for programs to support declining products and industries. For example, the farm price-support program, although aimed at protecting farm income, has delayed the shifting of some of our labor and other resources to the production of goods for which there is a stronger demand. We should recognize that policies which tend to postpone the shifting of resources from the production of goods in lesser demand to those in greater demand retard our rate of economic growth.

In this connection, I would like to cite part of an editorial that appeared in the May 1, 1959 issue of THE JOURNAL OF COMMERCE:

> "THE QUESTION is thus one of technological change. Much of the present unemployment is the result of advances in technology, and the problem of young workers in the mid-1960's pointed out by Commissioner Clague is also the result of the same causes.
>
> "Where the approach to unemployment must come then is through adjusting to our changing society. Federal programs aimed at retraining workers so they can take the new jobs that advances in technology are opening up are all to the good. Probably far more important are

programs to extend the training of this rising group of young workers so they will be able to fill the new jobs that are opening up. Otherwise the nation may be faced with a severe labor shortage in skilled work categories coupled with substantial unemployment in the lower ranks.

"Efforts that are directed at protecting workers' jobs through restoring past conditions may be partially successful for a time, but the basic problems they are meant to deal with will not disappear that easily. The answers must be found in adjusting to technological change rather than in resisting it, and Commissioner Clague points out there will be millions of unemployed young people testifying to the truth of this statement in the mid-1960's if nothing is done about it now."

Role of monetary policy.

It is obvious that monetary policy does not directly affect several of the basic factors which determine our long-run rate of growth. An easy-money policy, for example, does not increase the number of scientists or the flow of discoveries emanating from their laboratories; stimulate technological advances; or increase the willingness of laborers and entrepreneurs to shift from one industry to another. The principal contribution of monetary policy is indirect -- in helping maintain an economic environment favorable to growth.

History shows that our rate of economic growth has not been steady. It has come in spurts -- periods of expansion in total output and employment followed by periods of stability or even decline. This has led many to characterize ours as a "boom and bust economy." Our problem is to try to smooth out these fluctuations in order to achieve sustained instead of sporadic growth.

Avoiding booms and recessions is mainly a problem of keeping total spending in balance with the amount of goods and services available for people to buy. Too much spending and too few goods tend to push up prices and generate a boom; too little demand and spending slow production and lead to recession.

One of the principal reasons that total money demand tends to get out of balance with the total supply of goods and services is the use of credit.

Credit is a means of spending tomorrow's income for today's purchases.

A rise in business activity and employment is usually accompanied by strong demands for credit. Businessmen, expecting sales to increase, borrow to build up inventories and to expand their plant and equipment. Consumers, with employment prospects bright, borrow to buy homes, automobiles, and other durable goods. As production begins to press against capacity, however, credit expansion tends to finance higher prices -- not more production. Once prices begin to rise there is an additional incentive to borrow and buy now in order to avoid paying a higher price later. If unrestrained, credit expansion may create an inflationary boom which sooner or later ends in a recession.

Credit contraction also tends to intensify a slump in business activity and employment. When times are bad, businessmen and consumers are reluctant to borrow. Debt repayments usually exceed new borrowing. A part of current income is used to pay for yesterday's purchases. Thus credit contraction tends to reduce demand and bring a further decline in production and employment.

The Federal Reserve System, which is responsible for formulating and implementing monetary policy, tries to regulate credit and the money supply in such a way that they contribute neither to rising prices and an inflationary boom nor to a recession and falling prices. Specifically, Federal Reserve policies and actions are directed toward keeping the price level stable, and maintaining business stability at high levels of production, employment and income. Policies and actions designed to achieve these objectives are generally consistent with fostering sustained economic growth.

Reasonable price stability, although not sufficient, is essential for sustained economic growth. Rising prices induce waste and inefficiency, and divert energy and resources from production to speculation. Entrepreneurs strive to increase output. There is little inducement to increase efficiency and cut costs.

There is an incentive to buy before prices rise further -- to accumulate inventories and expand plant capacity. Time and energy are diverted from production to speculation. An inflationary boom creates distortions and maladjustments which undermine growth. The inevitable result is a slump in business activity and employment while excesses such as top-heavy inventories and excess plant capacity are corrected.

Falling prices, until recently characteristic of recessions, tend to aggravate the decline in production and employment. Businessmen and consumers, expecting lower prices, tend to defer purchases. Reduced demand brings a further drop in production, employment, and incomes, so that the decline tends to feed on itself.

In the postwar period, prices have risen in periods of expansion but have not declined during periods of recession. These recurring periods of rising prices not offset by declines during recession had led many to believe that the long-run trend of prices is upward -- that creeping inflation is inevitable. Some advocate slowly rising prices as a means of stimulating fuller use of our resources. Others think creeping inflation is a necessary and relatively small price to pay for a more rapid rate of growth.

I cannot accept these views. Creeping inflation is inimical to sustained economic growth. History clearly demonstrates that depreciation in the purchasing power of money, if long continued, becomes a strong deterrent to saving. Why should one abstain from consumption in order to accumulate savings deposits, savings and loan shares, savings bonds, or any other fixed-income obligation which is expected to shrink gradually in real value. An increase in the price level of 3 per cent annually would reduce the buying power of the dollar by one-half in less than 25 years. This shrinkage in the value of savings, pensions, life insurance, and other fixed-income obligations is not only inequitable, it dries up one of the principal sources of financing the improved plants and machinery so essential for increased productivity and real growth

Gradual erosion in the buying power of money also stimulates efforts to hedge against its adverse effects. Workers demand escalator clauses in wage contracts providing for automatic wage increases as prices rise. Investors favor common stocks, real estate, raw materials,-- investments which tend to appreciate in value as the value of money declines. Widespread efforts to hedge against the ravages of inflation accelerate the rate of price increase. History offers no hope that creeping inflation, once widely accepted and expected, could long be held to a creep.

The objective of keeping the total volume of business activity stable at high levels of production and employment is also consistent with maintaining a high average rate of growth. Attempts to maintain production and employment at maximum levels without regard to price stability may stimulate a higher rate of growth for a short time; but the resulting boom and distortions will eventually bring recession and a lower volume of production and employment. For the long pull, policies designed to prevent both unsustainable booms and recessions will result in a higher average rate of growth.

Limitations of monetary policy.

Recent developments illustrate the complex forces that limit the achievements of monetary policy. A year ago prices were still rising even though business activity and employment had declined. Today we have a vigorous, widespread rise in business activity, with total output and income already well above their prerecession peaks; but unemployment has remained sticky and remains relatively high.

These developments, as you probably know, have led to renewed discussions of Federal Reserve policy. As the System observed the vigor and breadth of the expansion in business activity, it shifted gradually from the policy of ease that had been appropriate during the recession. Some critics have felt that the policy of ease should have been continued until output was near capacity and unemployment reduced to a "normal" level.

Before I analyze these two views, I should like to clear up a misunderstanding. The misunderstanding is that Federal Reserve officials are less concerned about the unemployed than are their critics. Actually, the two views do not reflect differing degrees of concern over the unemployed. They reflect differences of opinion as to what monetary policy can do about it. Unemployment is concentrated in a few of the heavy durable goods industries, such as automobiles and primary metals, and in mining. The coal regions, for example, have long had a serious unemployment problem because of the declining demand for coal and increasing productivity resulting from mechanization. These pockets of unemployment are largely structural, reflecting the difficulties of certain industries instead of a deficiency of total purchasing power. The fact that personal income is at an all-time record is some evidence that the weak demand for the products of these industries is not caused by a shortage of money. Furthermore, the sharp increase in productivity which has accompanied the rise in business activity has retarded absorption of the unemployed.

An easier money policy is not a remedy for such structural unemployment problems. There is little reason to believe that it would accelerate significantly the reemployment of those now idle. Adoption of an easy money policy would, however, involve the risk of sowing the seeds of an inflationary boom which would end in another recession and more unemployment.

I cite these developments to indicate that monetary policy is only one of many policies that influence our rate of growth. It is unrealistic to expect a free economy to operate continually at full capacity and with uninterrupted growth to ever higher levels of production and employment. Changing wants inevitably result in some temporary unemployment and idle plant capacity while resources are being shifted. Temporary slumps in business activity arising from misjudged market prospects -- too much inventory, excess plant capacity -- are to be expected. Those responsible for monetary policy can only strive to minimize and shorten the duration of these temporary interruptions to economic growth.

Concluding remarks.

Monetary policy plays a significant but not a dominant role in determining our rate of economic growth. Its main contribution is in helping to maintain an economic environment that is conducive to growth.

Far more important in determining our growth are the choices we the people make between such alternatives as consumption or saving, work or leisure, and progress or security.

# # # # #