

OBJECTIVES OF POLICY

By

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STATED MEETING OF THE BOARD OF DIRECTORS
OF THE FEDERAL RESERVE BANK OF PHILADELPHIA
TRANSCRIPT OF REMARKS BY
PRESIDENT KARL R. BOPP

OBJECTIVES OF POLICY

Mr. Chairman, as you know, I have been in the habit of giving an opening statement each year when we usually have a number of new directors. This year, since Howard Petersen, our only new director, is familiar with the Federal Reserve System, I thought it might be appropriate to modify the procedure a bit. In addition, I find that after I have done the same thing eight or nine times, the steam goes out of it no matter how important it may be. I have, therefore, distributed to all directors a copy of last year's initial statement, modified only to bring the statistical material up to date.

At the next few sessions of the Board I shall comment at greater length on a number of items in the general statement. My remarks will reflect my basic philosophy and approach to problems of central banking. They will serve as a background that may explain why I come up with the specific recommendations that I shall make from time to time in the very complex economy that we have.

Today I shall discuss objectives of policy. You have before you a list of objectives that have been pursued by central banks and the monetary actions designed to achieve each of those objectives.

OBJECTIVES AND RELATED PROGRAMS

<u>Objective</u>	<u>Conditions Calling for or permitting an easing of credit</u>	<u>Conditions Calling for or permitting a tightening of credit</u>
1. Full employment.....	Less than full employment.	Jobs in excess of workers.
2. Stable price level.....	Declining prices.	Rising prices.
3. Convertibility of the currency.....	High and/or rising primary international reserves.	Low and/or declining primary international reserves.
4. Adequate growth.....	When growth is inadequate.	When growth is too rapid to be sustained.
5. A fixed rate of interest	When savings are inadequate.	When savings are excessive.
6. Productive credit.....	Increase in monetary volume of output.	Decrease in monetary volume of output.

I have included No. 5 -- A fixed rate of interest -- and No. 6 -- Productive credit -- only because they have actually been advocated and indeed been pursued by central banks. In my own view a fixed rate of interest is incompatible with a dynamic free enterprise economic system and productive credit is a tantalizing notion but quite irrational in real economic terms. I shall be happy to develop these conclusions on another occasion, but prefer not to do so today.

I think there would be general agreement that we would like to have our economic system achieve the first four objectives on the list. When I first studied money and banking in the 1920's, we demonstrated with careful economic analysis, that these objectives were internally consistent and achievable.

Stripped of qualifications, the essence of our analysis ran something like this. Suppose you start with an economy in recession. The recession would be characterized by less than full employment and falling prices (in those days

(Objectives of Policy, p. 3)

the general level of prices, not merely individual prices, fell as well as rose). The lower prices would tend to increase exports and to reduce imports. The resulting favorable balance of trade would be paid for with gold. Thus, in recession all objectives would call for an easier monetary policy.

The purpose of the easier policy would be to stimulate demand. The initial impact of enlarged demand would be on volume, more employment and greater utilization of plant and equipment. Profits would rise because fixed costs would be spread over the larger volume.

As revival continued, operations would approach efficient capacity levels and unemployment would decline. As unused margins shrank, prices and wages would rise. The favorable balance of trade would be reduced and ultimately be succeeded by an excess of imports over exports. At this point all objectives would call for monetary restraint.

I must confess that the logic of this analysis was compelling to us in the 1920's. It still sounds convincing, granted the inarticulate premises.

Doubts concerning these premises arose in the early 1930's, when, despite what was thought to be relatively easy money for a considerable period of time, revival failed to appear around the corner.

Many individuals concluded that monetary policy is a completely impotent tool of economic policy. Fiscal policy, which was brought into the discussions as a supplement to monetary policy, emerged by supplanting monetary policy entirely.

This shift in emphasis was reflected in graduate enrollments. Money and banking was a popular graduate major in the 1920's. It all but disappeared for a couple of decades from the mid-1930's. In recent years many students have again become excited about monetary theory and policy.

These developments have influenced my own thought. I have developed

(Objectives of Policy, p. 4)

some convictions but I am less certain than I was forty years ago. I hope I am still young enough to learn as experience unfolds.

You have before you a set of charts, which portray in quantitative terms the extent to which we have achieved the first four objectives since 1957.

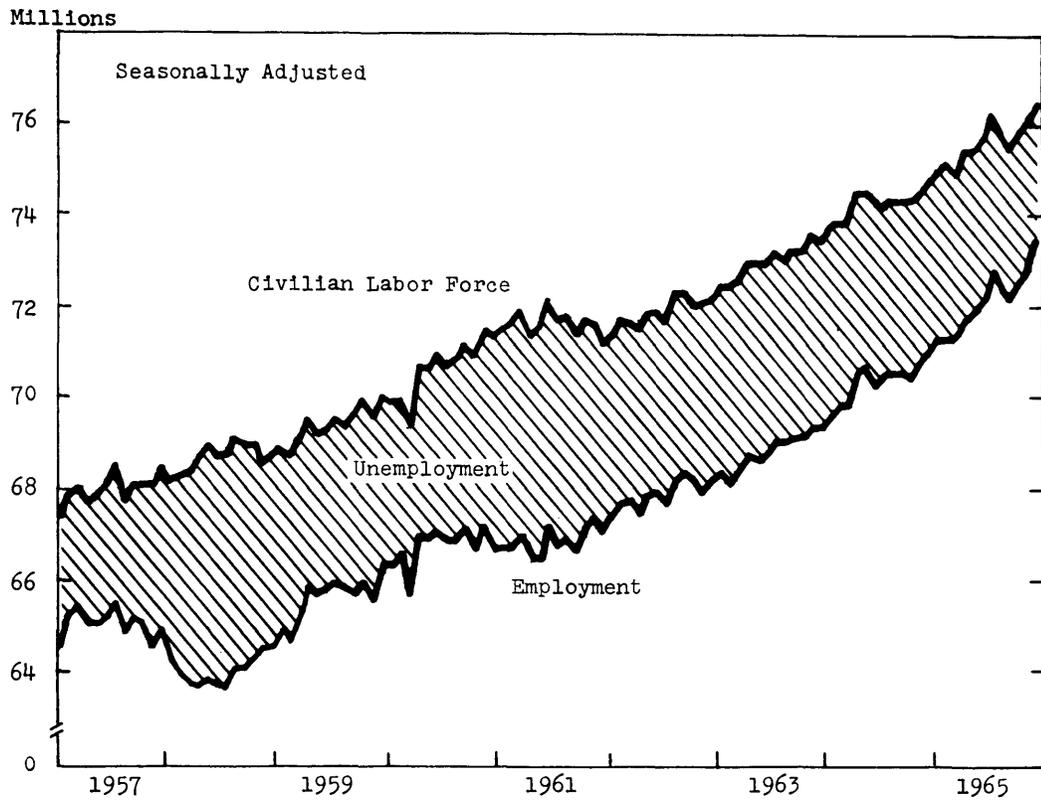
I. Full Employment.

The first set of charts (p. 5) relates to the full employment objective. This objective is of great importance in its own right. It is a serious tragedy when a qualified person wants a job and cannot find one. I feel very deeply about this. I recall a period after the First World War when my father, an excellent union carpenter, sought a job diligently -- but in vain -- day after day for months. I recall my early days on the faculty at the University of Missouri when graduates in all fields with long and successful experience came back desperately looking for jobs -- any kind of a job.

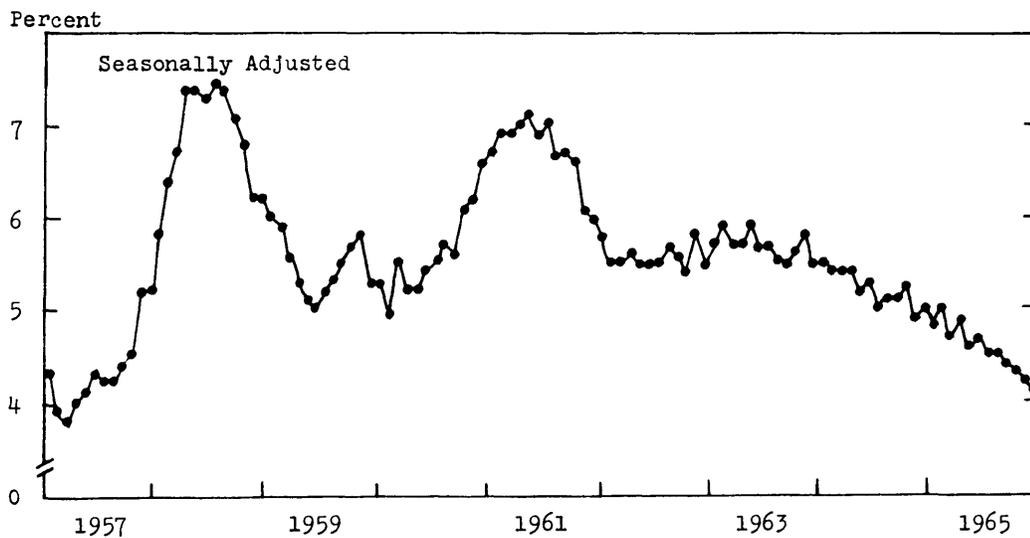
Unemployment, particularly widespread unemployment, affects not only the individual who is unemployed but also his immediate family. It has widespread social consequences. When many people are idle they have ample time to create trouble. This is true particularly if the idle are young or are disadvantaged in other ways. A significant part of our social unrest has arisen from unemployment. Prosperity reduces the general level of our social problems.

If, now, you look at the chart on employment, you will note the significant growth that we have experienced, with only a small interruption in 1958. The charts also reveal, of course, that employment is related to the size of the civilian labor force. If you look at recent years a bit more closely, however, you will note that the size of the labor force itself seems to be influenced by the level of employment. What seems to happen is that when jobs are easy to get and employment rises rapidly, many individuals,

CIVILIAN LABOR FORCE AND EMPLOYMENT



UNEMPLOYMENT RATE



(Objectives of Policy, p. 6)

particularly women and teenagers decide to seek jobs and thus enter the labor force. When jobs are hard to get and employment is rising slowly, they simply cease looking and leave the labor force.

It was during this period, you may remember, when unemployment was consistently running above 5 per cent that I argued against increasing monetary restraint. I have been placed with some strange bedfellows for taking this position, but a central banker should not change his view because he may be falsely accused. This Bank, in turn, was a little slower than some in favoring increased restraint. We went along with the System but we did not lead the parade.

I should now like to digress for a moment to call attention to a facet of this problem which is not given in the charts here. This concerns the possible availability of human resources should we move from where we are to an all-out war with full effort. There are those who feel that with unemployment at something like 4 per cent there would be no real unused human resources that we could devote to such effort. I do not personally happen to agree with this, although obviously the amount of additional manpower is not as great as it was before the Second World War. Nevertheless, the per cent of our population which is in the labor force is not at a peak. The number of noninstitutionalized individuals who are 14 years or older is running in the order of 137 million people. Of these, 78.7 million are in the work force and that is 57.5 per cent.

During the Second World War, in 1944, this figure reached an annual average level of 63.1 per cent. The difference is 5.6 per cent, or roughly 7.5 million people that could be brought in. Now this might not be enough to take care of a full-fledged war, but I think that if the pressures are great enough, we still have the human resources.

(Objectives of Policy, p. 7)

On the other hand, short of that, I would have the judgment that to pull these people not only into the labor force but to get them jobs would require a degree of inflation that I think would be intolerable. So I think this is a resource which is there for use in case of emergency and, as I say, I think there is such a resource, but it is not one that I think we could really use and still hope successfully to achieve our other objectives as well.

I return now to some policy implications of the stubbornness that has developed in the rate of unemployment, despite rapid increases in employment. In earlier times revival quickly brought down the rate of unemployment. In 1958-1959, for example, unemployment was reduced by a third in less than a year, from 7.5 to 5 per cent. The stubborn level now appears to be a rate of about 5 per cent.

If employment were our only objective, we would, as the table shows, pursue an easy money policy until we had no unemployment or only perhaps seasonal and transitional unemployment. But we have other commendable objectives. The critically important question for policy-makers is what level of unemployment is implied to achieve the appropriate mix of over-all objectives. The answer one gives to this question involves value judgments as well as economic analysis.

Many competent individuals have expressed their views on this matter and views of many have changed over time as we gain more experience. The primary reason for being tempted to insist on a very low figure is genuine concern for the plight of the individual without a job. Pointing to a low rate also are the achievements of such rates by ourselves during the war and by a number of our highly industrialized competitors in recent years. Pointing to caution in striving for too low a rate are the undesirable consequences that flow from inflationary pressures when aggregate demand is excessive.

Unfortunately, the problem is not static but dynamic. A policy-maker

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can tolerate a bit more unemployment if the economy is moving ahead than if it is falling further behind.

Selection of a specific rate is influenced also by judgments as to the accuracy of the relevant measurements, as to the minimum level of transitional unemployment, as to the extent of structural unemployment, as to the residence, skills, and qualifications of the unemployed, and similar factors.

My own view is that for the present we should pay increasing attention to other objectives when the unemployment rate approaches and passes through the 4 per cent level. I envision higher standards for the future. To achieve them, however, requires a successful attack on ignorance, inadequate training, and discrimination. Success also will require more rigorous economic analysis, more information (e.g., on job vacancies by type and location) and better information (more accurate and more complete on labor force, employment, and unemployment).

II. Stability of the Price Level.

I move now to the objective of price stability. Our interest in the price level is not quite as direct as our interest in employment. We have no particular interest in the absolute level of prices as such. If, throughout our history, the price of every good and every service had been exactly twice what it has been in fact, we would be today precisely where we are in real terms, even though all dollar prices, of course, would be double what they are.

Our interest in the price level derives from the evil consequences of changes in it. Changes in the price level redistribute wealth and income inequitably. A period of rising prices robs the creditor for the benefit of the debtor because it enables the debtor to repay with cheaper dollars than he borrowed. A period of falling prices robs debtors for the benefit of creditors.

Changes in the price level also produce unwise business decisions. Business decisions are based on dollar magnitudes on the assumption that the

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unit of measure, the dollar itself, remains constant. Since the businessman is concerned with maximizing profits in the long run, he is necessarily vitally interested in an accurate measure of what his profits actually are. A changing price level, however, produces a distorted view of profits.

Inventories and depreciation afford excellent illustrations of the distortions. The process of production is a lengthy one in which the businessman buys before he sells. He buys countless raw goods to be funneled into his factories and machines and he usually keeps some inventory of his finished products. If, month after month, prices are rising, then this stock appreciates on his hands. He is continually selling at a price better than he expected and hence securing a windfall "profit."

These profits are inflated for another reason. It is clear that a manufacturer wears out his plant and equipment as he produces his output. Such wear and tear, or depreciation, is a cost of production. By the time the asset is completely worn out, enough depreciation should have been charged to replace it. If, however, depreciation is computed on the basis of original cost and prices have risen during the life of the asset, the depreciation allowance will be inadequate to replace it. The cost of depreciation will have been understated and profits correspondingly overstated. George Terborgh has estimated that the inflation in the decade 1947-1956 resulted in overstating corporate profits by \$43 billion. Reported profits were \$187 billion, whereas true profits were \$144 billion. It does not take much imagination to appreciate that business decisions may be irrational if they are based on the assumption that profits are 30 per cent higher than they really are.

Here, then, sits the businessman, his profits inflated by windfall inventory gains and by understated costs. The future looks rosy indeed. Expectations of future sales and profits lead him to expand his plant and equipment. Rosy expectations also lead him to accumulate greater inventories,

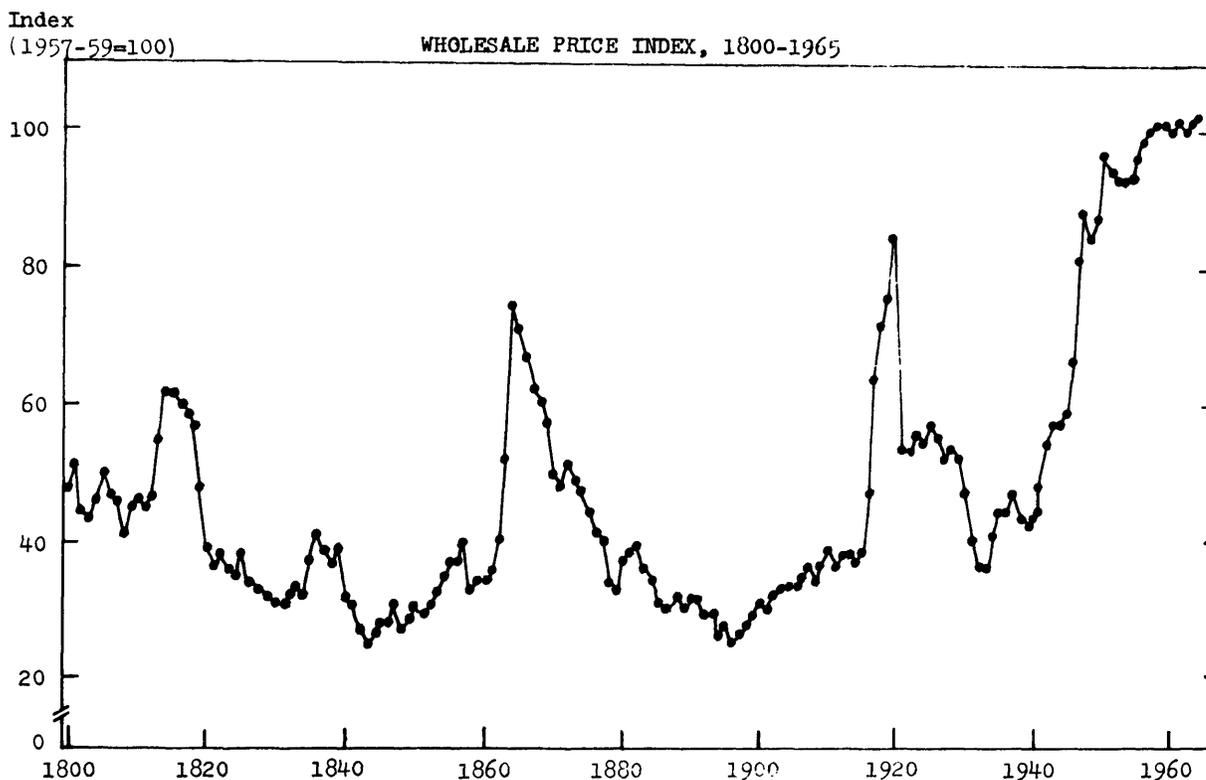
(Objectives of Policy, p. 10)

both because his sales are rising and because he desires to lay in more stock before the prices of that stock rise. In short, we have a typical inventory and capital spending boom.

Things go on rising for a while but then the bubble bursts. The businessman realizes that additions to productive capacity have outrun consumer demand. He realizes that his inventories are high relative to any reasonable forecast of sales. He cuts back on inventory purchasing and capital spending. The firms which supply him with inventory and which build his plant and equipment are forced to cut back their production and lay off workers. Then, like a pebble dropped into a pond, the effects spread. Other firms selling to the second group of suppliers and builders find sales declining. More workers are laid off and hence consumer income falls. With income declining, business sales fall even further. In short, we have the familiar downward spiral of business into the depths of recession, a recession which will continue until top-heavy inventories and excess plant capacity are corrected. Once more inflation has helped breed the excesses which result in recession.

I move next to the history of prices. You have before you a chart of wholesale prices since 1800 (p. 11). Now, there are very great hazards in interpreting a chart of prices over the very long term. The reason is the obvious one that the things our forefathers actually bought and sold are, with some rare exceptions, not the same things we buy and sell. There are hazards in long-term price comparison. Nonetheless, I think we can draw some general conclusions of contemporary relevance from an index of prices over the long run.

It is perfectly clear that we have had four major inflations in our history. These have all been associated with war: first, the War of 1812; second, the Civil War; third, the First World War; and, finally, the Second World War. The great inflations have been war-induced inflations -- that's point one.



If you look a little more carefully, you see a significant and rapid increase in prices in the 1830's -- actually 1832 to 1837. This one, it seems to me, was essentially a product of President Jackson's successful war against the Second Bank of the United States. As you know, he destroyed the Second Bank of the United States and ushered in an orgy of new banks with state charters. This is a period of wildcat banking in the United States which resulted in a great expansion in our money supply via a very inferior kind of banking system. And the net of all this increase in the money supply was a significant increase in prices.

The second significant rise -- though nothing like the very tall ones -- you will notice came in the decade of the 1850's. All you have to do is recall 1849 to reach the correct conclusion that this was clearly a consequence of the gold discoveries in California and in Australia. The third of these

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secondary increases in prices came from the late 1890's up until the First World War, roughly. This again was a result of gold discoveries -- this time in the Klondike and Cripple Creek -- which led to very rapid expansions in our total money supply. Finally, we have the rise from the late thirties up to the Second World War. This followed the revaluation of gold. So that these have all been associated with monetary phenomena, either changes in the base or discoveries of new primary money in the form of gold.

I move next to the great declines. They have followed wars. You see the significant decline after the War of 1812 to roughly 1820. After the Civil War, we have another long continued price decline. Again a decline after the First World War.

Interestingly enough, we did not have a decline after the Second World War. Many people predicted that we would. Sewell Avery, for example, was determined that this was going to happen. The lack of progress of Montgomery-Ward in the post-Second World War period is a reflection of his error of judgment. In my view, this new post-war experience was not an accident. It seems to me to illustrate that human intelligence applied to problems can, if everything works out well, produce desirable results. We did not have the anticipated great price decline because of public and private actions to prevent it. Organizations like the Committee for Economic Development were founded to develop and promote a smooth transition to peace. It was felt deeply that if we had another terrific recession the whole fabric of society might not hold together. So there was determination to do something about it. We did not talk about a return to pre-war normalcy or anything like that. We did do something about the real economic problems that were involved. The Employment Act was passed in 1946.

You will notice that the very rapid declines following wars were in turn followed by long-continued but slower price declines. The development after the War of 1812 was interrupted by the Jackson episode that I have men-

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tioned. These were periods of great social suffering, difficulties, and unrest. One need only recall 1848 -- one of the watershed years in modern Western history. In my view, these were primarily the result of an inadequate supply of the means of payment for the entire Western world, resulting from an inadequate supply of gold. The inadequacy was aggravated by the decision of important industrial countries to adopt the gold standard (e.g., Germany after the Franco-Prussian War).

As I mentioned earlier, declining prices put pressure on debtors and may even force them into bankruptcy. The persistent price decline after the Civil War had much to do with the development of greenbackism; the free silver movement; and similar so-called radical movements. I think the debtor class simply would not tolerate what was happening to it. In my view the gold standard would have ceased to exist as an international standard had it not been for the wholly fortuitous discovery of gold in California in 1849 and the wholly fortuitous discovery of gold in the Klondike and Cripple Creek in the 1890's. Had these discoveries not occurred I think the gold standard would have collapsed.

One conclusion I draw from this long experience is that our economic system has no inherent tendency toward either inflation or deflation and that we should be aware of the dangers and guard against both.

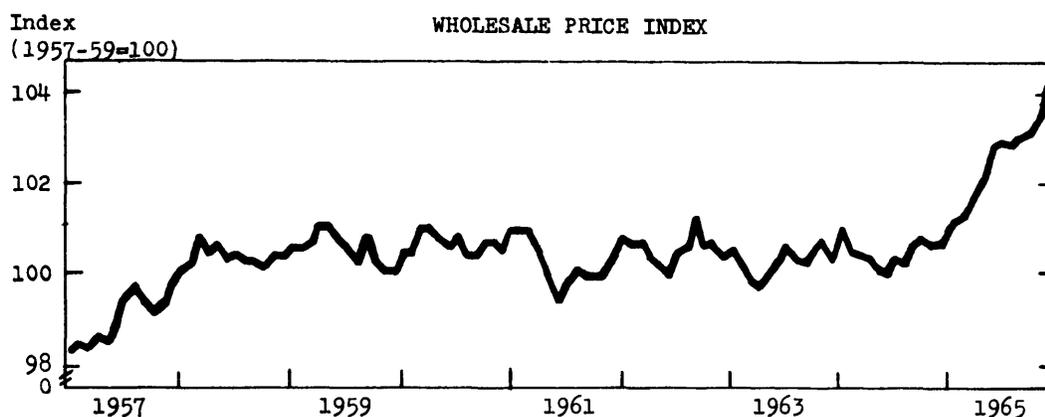
There always have been some who have felt there is an inherent tendency toward deflation. Usually they have been engineers or production men who emphasize that increasing efficiency reduces real costs. Of course it does, but one must not confuse real costs with money costs. Wage rates obviously can go up faster than output per unit of time.

Others, who usually emphasize this latter possibility, insist that our economy has an inherent tendency toward inflation. In recent years they

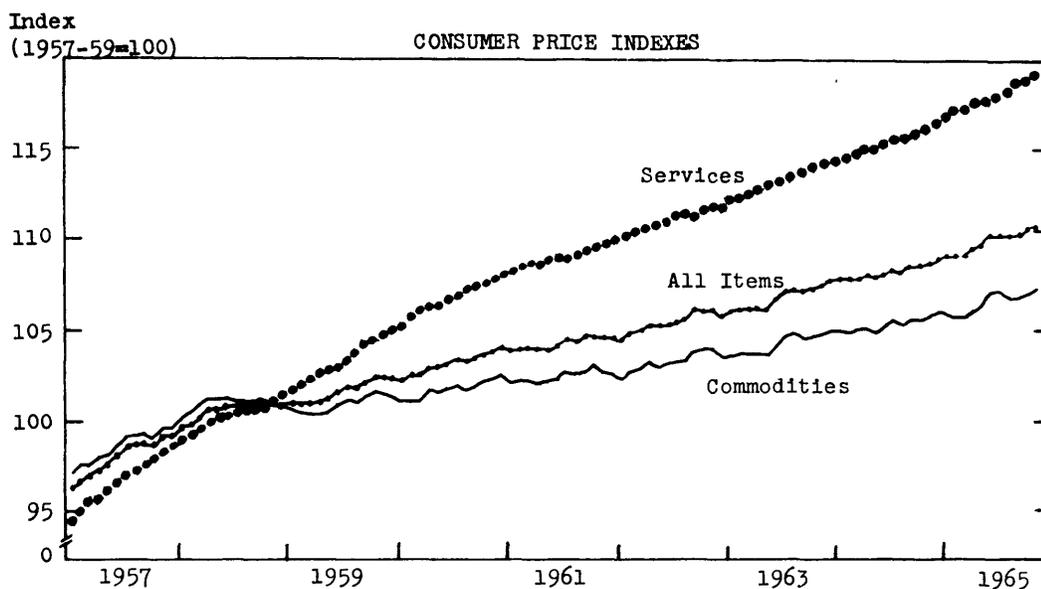
(Objectives of Policy, p. 14)

have based their argument largely on the increased power of labor unions. To me, this is a new version of an old argument. The same complaint, in different terms, can be heard throughout our history. "Men don't work the way their fathers used to work." "They loaf on the job." "Quality isn't what it used to be." This is nostalgia for a society that never existed in fact.

My own view is that there is no inherent price tendency in our economy. Prices are a result of the monetary institutions that we create and the skill with which we manage them. This view is reinforced by our experience after the Second World War and in the past eight or nine years. I do have some reservations on how well we will in fact manage in the period ahead.



I move now to the story of prices since 1957, and begin with wholesale prices. From the middle of 1957 until the beginning of this year the index varied between 99 and 101 per cent of the 1957-1959 average. If you recall the long-run chart, it is clear that we have not had as long an interval of stability in more than 150 years. No other modern industrial country has ever experienced such an interval of stability. We have, however, as the chart shows, broken out of this range on the upside with a full year of virtually continuous, though slow, upcreep.



I move next to the consumer price index. Our record here apparently has not been as good. The primary reason has been the persistent increase in the cost of services. There is a widespread judgment of qualified individuals that this index probably has an upward bias because of improvements in quality. You might be inclined initially to dispute this judgment. You might have in mind, for example, the cost of medical services, including drugs. Doctors now rarely make home visits; office calls are brief; drugs are expensive. If, however, one keeps in mind the service performed -- curing the patient -- the story is different. Time was when pneumonia was frequently fatal and even recovery was long drawn-out. It was a costly disease, directly and in terms of time lost from work. I have a hunch our forebears would have considered a modern cure cheap even for their time, but it was not available.

Improvement in quality has come also in goods as well as services. Take the automobile tire. I can remember when Sears Roebuck guaranteed tires for 3,000 miles and how boldly they advertised when this was increased to 5,000 miles. Imagine anyone even trying to sell such a tire today. Unfortunately,

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we have not devised a statistical technique to measure changes in quality accurately.

If quality changes could be measured it is quite possible that an accurate consumer price index would reveal no upward drift at all. In any event, until very recently we have done very well with price stability as an objective of policy.

III. Convertibility.

I move next to convertibility as an objective of policy. For the United States this still means redemption of currency in gold at a fixed price. Since this objective, more than any other perhaps, arouses great emotions, it might be worth-while to see how England came to adopt the gold standard in the first place.

Macaulay wrote: "In the autumn of 1695, it could hardly be said that the country possessed, for practical purposes, any measure of value of commodities. It was a mere chance whether what was called a shilling, was really ten-pence, sixpence, or a groat." For example, the exchequer found that coins which should have weighed 220,000 ounces actually weighed only 114,000 ounces.

William and Mary appointed a committee to make recommendations for solving the problems. The membership was quite extraordinary: Sir Isaac Newton, Master of the Mint, John Locke, the great philosopher, and Lord Somers.

Sir Isaac recommended that the government call in the old coin at face value and issue new full weight coins and that the ratio of silver to gold be established at 16 silver to 1 gold (shades of Bryan!). In major countries on the Continent the ratio was $15\frac{1}{2}$ to 1. Sir Thomas Gresham could have predicted the results a century before! Relatively, England overvalued gold and the Continent overvalued silver. Gold was taken to England for exchange into silver, which was taken to the Continent for exchange into gold, which Newton later recognized his error and recommended that it be corrected, but this latter

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advice was not followed ^{1/}.

A century passes and England is once again involved in war with her old enemy, France; this time under Napoleon. She abandons redemption of the currency but decides to resume convertibility after the war. The mint, of course, had very little silver to coin and Lord Liverpool decided to close it to the free coinage of silver because England was "naturally a gold country" and that "gold was the natural currency of England." And, indeed, it was if one admits, as he should, that it is only "natural" for even a Sir Isaac to make a mistake and for this mistake to have "natural" consequences.

It is irrelevant but tempting to speculate what might have happened if Sir Isaac had made a mistake in the other direction, say by adopting a ratio of 15 to 1. England might well have become "naturally a silver country." With the role that sterling acquired on the basis of English leadership in industry and commerce throughout the world, who knows, the world might naturally have been on the silver standard.

These are irreverent conjectures. Still, the faithful have propagated some fictional natural history. One gains an impression that the gold standard existed for centuries without interruption. Yet it has not existed in modern times for as long as a century, though England almost made it from 1822 to 1914.

My own view is that England arrived on the gold standard because of a mistake by Sir Isaac Newton in 1696. The gold standard survived the nineteenth century only because of the miracles of new gold discoveries in the 1840's and 1890's. Finally, when one sees the incredibly small amount of gold frequently held by the Bank of England, he is forced to conclude it was not a self-regulating system but was in fact maintained through management by the Bank of England.

^{1/}This is the story as told by George F. Warren and Frank A. Pearson in their PRICES, New York, 1933, p. 159.

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Thus, a mistake, miracles, and management describe the System more accurately than does a mystical natural providence.

Do not misunderstand me. I think that on balance an international monetary system -- essentially this means a system of relatively fixed rates of exchange -- is preferable to a system of national currencies with freely fluctuating rates, despite its presumed intellectual attractions.

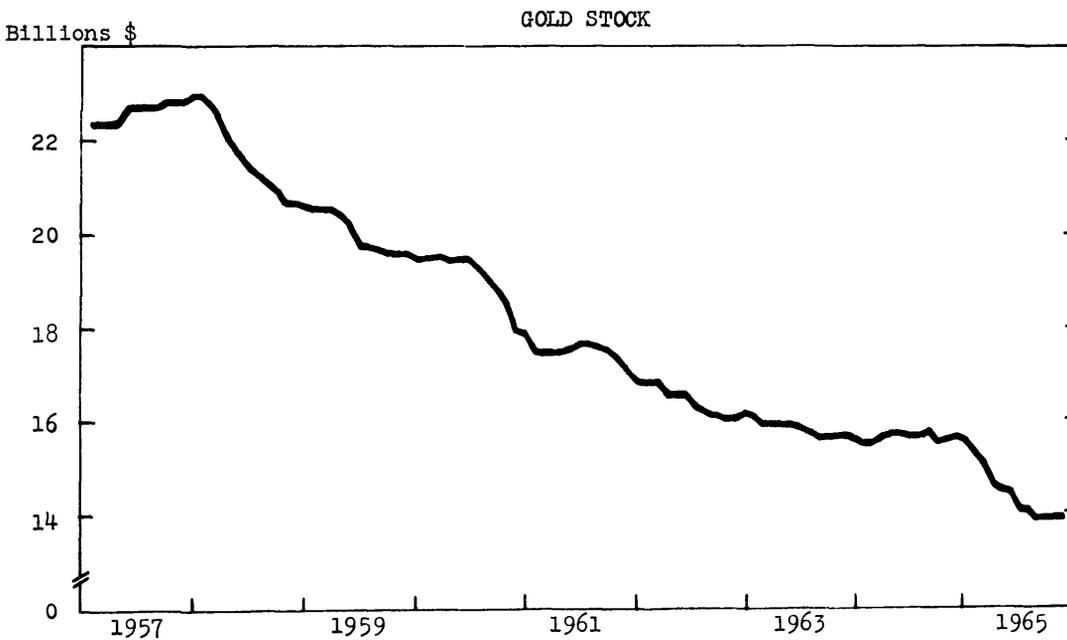
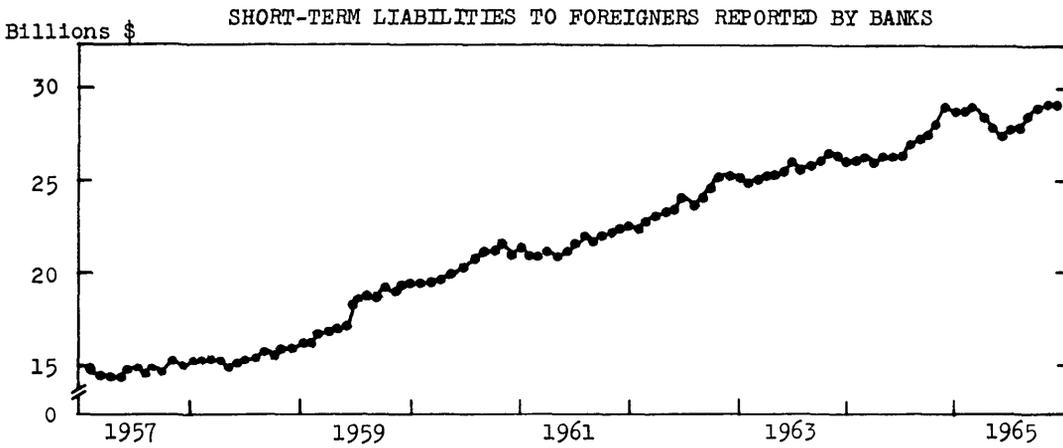
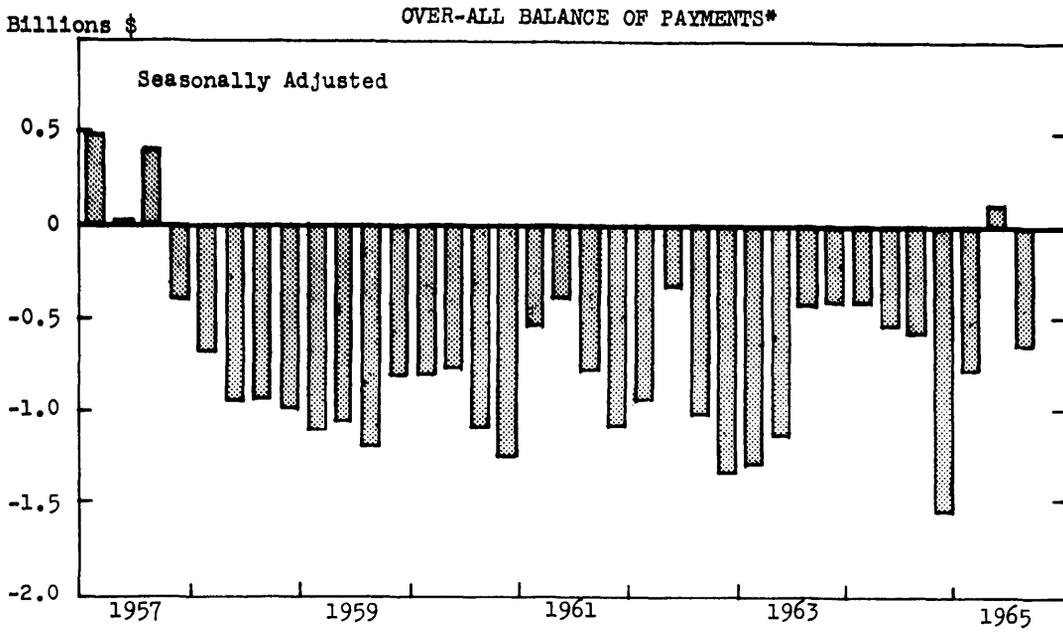
An international system, however, requires genuine international cooperation on the part of the members based on rational economic principles. Such a system should indeed put pressure on a member which has an unfavorable balance of payments because it has pursued policies of over-full employment and inflation. It should not, however, put pressure on a member that has an unfavorable balance of payments despite significant unemployment and stable or even falling prices.

As you know, negotiations are now in process to reform and supplement the international monetary system. Fortunately, we are not at the moment operating in a crisis atmosphere.

I move now to recent developments in our balance of payments. As you can see from the chart (p. 19), we have been running at a persistent deficit ever since the Suez crisis in 1957. Throughout this period (except for a brief interruption in 1959) we have had a large excess of exports over imports of both goods and services. This excess, however, has not been large enough to finance our foreign defense, Government aid, and private investment abroad. As a result our short-term liabilities to foreigners have doubled from about \$15 billion to about \$30 billion and our gold stock has declined from over \$22 billion to less than \$14 billion.

IV. Growth.

This brings us to the last objective I shall discuss this morning: adequate growth and a rising standard of living. Barring a nuclear war, our



* Before special government transactions

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children and grandchildren are almost certain to have a higher standard of living than we enjoy. For them, the hard core of our basic economic problems may be solved. This may not be an unmixed blessing. There is joy and importance in work. The thrill of the craftsman at whatever task is one of life's real satisfactions. Long hours of leisure are not necessarily satisfying, even when they are voluntary.

Monetary policy has relatively little to do with the germinal elements of growth. One of these ingredients is the sporadic appearance of genius, frequently motivated by what most people consider a naive desire to comprehend: Newton, Descartes, Harvey, Gibbs, Einstein, Fermi. Another ingredient is the application of knowledge to invention: Burbank, Edison, Firestone, Ford; and to human organization: Taylor, Mary Follett. Other ingredients are the character of a people and availability of natural resources.

My own view is that, although a central banker should be interested in growth as is any responsible citizen, he should not establish any specified rate of growth as a specific objective of monetary policy. He should, instead, concentrate on achieving the best balance among the three objectives that I have already discussed.

Hopefully, this will produce a maximum sustainable use of available resources. This, in itself, is a large contribution to growth. Beyond this, however, the actual rate of growth depends on matters that are not reached directly by monetary policy. One of these factors is how hard and long we wish to work. It has been estimated that in the past fifty years we have taken about half of our productivity gains in the form of increased leisure and about half in the form of more output. We could grow much faster if we worked longer and harder.

Another factor is how we divide our actual output between consumption

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and investment. The more we consume the less remains available for investment to increase our growth. It is an appropriate role of Government to influence consumption, saving, and investment through fiscal policies, but it is not a primary responsibility of the monetary authorities.

The important concern of the central bank should be to contribute all that monetary policy can contribute to full utilization of resources. It is the responsibility of the individual citizen and the Government to determine the distribution of our total resources between work and leisure, between consumption and investment.

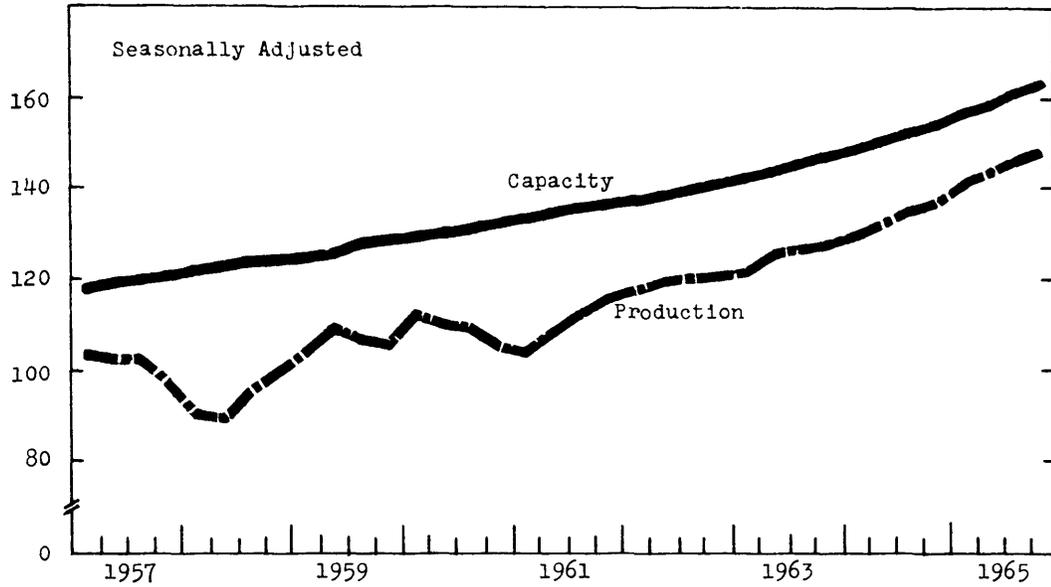
You have before you (p. 22) charts that reflect as best we can capacity and output of our manufacturing industries. As you can see, production has only recently exceeded 90 per cent of capacity.

I hope, Mr. Chairman, that this brief statement will give you a general idea of my basic philosophy and prejudices. My recommendations on monetary policy arise from the application of these principles to developments in the economy. You will recall that until very recently I have been slow to recommend increasing firmness in credit conditions. The primary reason has been the persistence of excessive unemployment, the stability in our price level while those of our international competitors were rising. In my view these factors outweighed our adverse balance of payments and gave hope, indeed, that it too could be rectified.

Recently, however, we have come far closer to full utilization of our manpower and productive resources and prices have risen. These developments, in my view, fully justify the recent actions of the System.

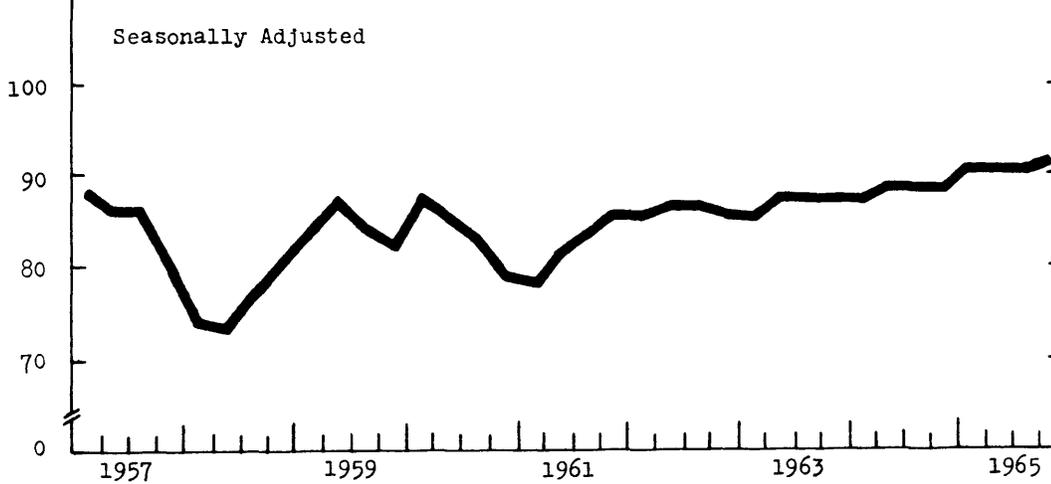
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MANUFACTURING CAPACITY & PRODUCTION



CAPACITY UTILIZATION RATE

Percent



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