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DOLLAR DECISIONS

Address of Eliot J. Swan, President, Federal Reserve Bank of San Francisco, before the Annual Meeting of the Trust Division of The American Bankers Association, Civic Auditorium, San Francisco, Monday Afternoon, October 16, 1961. The meeting was held as a part of the 87th Annual A.B.A. Convention.

History is an account of change, and the postwar period has seen many breathtaking changes indeed. Yet, despite the uncertainties, confusion, and crises that seem to confront us without end, we would agree, I believe, that a growing and dynamic economy in which we rely mainly upon individual decisions must be based upon a significant range of choice, exercised by consumers and producers, by employees and employers, by spenders and savers, and by borrowers and lenders. For this exercise of choice to be meaningful, there must be opportunity for private economic decisions made through, and in response to, basically impersonal market processes, rather than having detailed directions issued by central authority to govern our behavior. Let me hasten to add that I am not recommending a return to laissez faire. Though we may still differ considerably as to degree, few would seriously argue that there should be no restrictions upon private economic choices and decisions, and no influence at all exerted by government upon market forces. We not only accept but also expect government to assume many responsibilities in this regard, but essentially our economy relies primarily upon market forces to determine the volume and the kinds of goods and services we are to have.

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The Federal Reserve System is one agency that has definite responsibilities with respect to money and credit; and in this kind of economy, it is a popular pastime to try to outguess actions of the Federal Reserve System before the fact, and perhaps even more popular to second guess such actions after the fact. I am not objecting to this--it is simply one of the occupational hazards confronting central banking.

As you are well aware, Federal Reserve actions directly affect the reserve position of the banking system. By expanding or contracting the lending capacity of banks, the System can directly influence the total of bank credit and, hence, of bank deposits, and thereby indirectly affect the cost and availability of credit extended by other lenders.

Public decisions of another kind, affecting the flow of credit in our economy, are those often described as relating to fiscal policy and debt management--congressional decisions regarding taxes and expenditures, which are basic to whether the government shall have a surplus or a deficit, and decisions of the Treasury regarding the rates and maturities it offers in borrowings from the public, whether to raise new money or to refund maturing issues. The actions of the Reserve System, of the Treasury, and of Congress both affect and are affected by the many dollar decisions reached by individual and institutional spenders and savers, lenders and borrowers. Even the Treasury, as we all know, must come to the market and, in competition with other seekers of funds, offer sufficiently attractive terms to persuade investors to buy its securities.

Another area of decision significantly affecting the dollar, which has suddenly loomed important, particularly since mid-1960, is that of the foreign holders of dollar claims. Successive deficits in our international balance of payments have resulted in a rising volume of foreign claims to dollars, and the spread of currency convertibility has given such holders a considerable range of

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choice among the important currencies of the world. The interest rate differentials and other uncertainties that developed in 1960 led to a substantial outflow of short term funds and an outflow of gold which reached disturbing proportions in late 1960 and early 1961. The fact that our short term liabilities to foreigners have risen so rapidly relative to our gold stock is the basis for concern. In 5 years, the ratio of such liabilities to our gold stock has risen from below 70 per cent to about 125 per cent. While this seems to many a new and uncomfortable situation to be in, I would point out that this is a far from unusual experience for other nations that have acted as bankers to the world.

In less than a year and a half we have experienced a mild recession, a quick recovery, and some expansion. During the downswing, the Federal Reserve acted promptly to expand the lending capacity of banks, which was reflected in a shift from heavy borrowings of reserves early in 1960 to low levels by the end of 1960 and through 1961 thus far. Without reviewing the System's specific actions in detail, I would remind you that these steps, directed first toward increasing and then toward maintaining a situation of relative monetary ease, were made more difficult by the outflow of short term capital and gold, which made it necessary to consider the international, as well as the domestic, effects of lower short term interest rates. A significant policy action associated with this problem, again as you are well aware, was that since February the Federal Reserve System has been operating in all maturity sectors of the government securities market, not just in the short term area. In fact, in the latter part of 1960, other steps were taken, such as allowing all vault cash of banks to be counted as reserves, to enable the System to supply additional bank reserves in order to promote recovery, and at the same time to minimize the downward impact upon short term rates. The Treasury, in its securities offerings, has sought much the same end with respect to interest rates by concentrating the bulk of its new issues in the shorter term area. Increasing the supply of course tends to hold prices down--and yields up--in that

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area, and minimizes the competition of the Treasury with private borrowers for long term funds.

1961 has seen continued ease in bank reserve positions and an expansion of bank credit, although the demand for bank loans has not been strong. Interest rates have been relatively stable, and in its recent financing program the Treasury has raised some \$5-billion in new money, with remarkably little effect on the rate structure.

The recovery has been broadly based, and has occurred without some of the pressures, as yet, which might have been anticipated several months ago, in considerable measure because consumer spending and borrowing has been quite restrained relative to the rise in personal income. (Whether the 1962-model automobiles will change this attitude appreciably remains to be seen!)

The rate of unemployment has stubbornly continued to resist decline, and there are no widespread indications yet of real pressure upon industrial capacity. We all remember the high hopes of a few years ago for the Soaring Sixties, but in 1960 we had a recession. This reflects, some would charge, the stocking up by consumers over the past 15 years since World War II, the growth of foreign competition in our markets, and the sluggishness of our enterprise system in responding to strong shifts in consumer tastes and to technological changes. Why be alarmed about inflation when wholesale prices today are where they were about 3 years ago? What is needed, according to these observers, is a forced draft to fan the flame of business, whether in the form of larger government deficits or in the form of the creation of a significantly easier money situation.

As in most such matters, we have to admit the relevance of some of these factors (and I must admit to having exaggerated slightly), and recognize that they have served to dampen some of the optimism of earlier years.

However, international tensions, which have already brought about an expansion in our defense program, may well require still further military spending.

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The emergence of new nations in an unsettled world means that we may well be faced with the need to supply more rather than less funds for development abroad. A larger government deficit is clearly in prospect for fiscal 1962. Current business and consumer liquidity are sufficient to support a considerable increase in private spending at home. Further expansion in business activity may increase upward pressures on costs and prices, even in the face of unemployment and idle capacity since these are not distributed evenly throughout the economy.

Inflationary pressures are not dominant at this point, but on balance it seems only prudent to be alert to the possibilities of their renewal. If this develops, we should not shrink from application of the monetary and fiscal discipline required. We can hardly expect higher taxes and less easy credit to be welcomed eagerly by taxpayers and borrowers. However, if the alternatives should be either surrender to inflation or a network of direct controls over prices, wages, and credit extensions, then taxation and general credit restraints become, relatively at least, much less forbidding, and they are far more consistent with the functioning of an enterprise economy.

Direct controls may be necessary in a national emergency, but their effectiveness depends upon general public agreement about the necessity of priorities in the production and use of specific goods. If particular political or economic groups have enough power to withstand one form of economic discipline, it is not likely they would submit to another.

Any reemergence of an inflationary situation would, of course, be aggravated by the fact that our balance of payments problems are by no means solved. To find our world competitive position weakened by a higher cost and price structure would be to worsen our balance of payments problem, because exports would be discouraged and imports encouraged. Such developments would also increase the possibility of a renewed outflow of short term funds and gold that might again, and perhaps more seriously another time, shake world confidence in the dollar, with unfortunate effects upon many other countries, as well as our own.

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However, to seek to solve our balance of payments problem by restrictions that would shrink our foreign trade and investments would certainly be to follow a counsel of defeat. The fact that our success in helping to create world conditions conducive to freer international exchange has itself been accompanied by problems should not blind us to the basic advantages to all concerned of a growing volume of international commerce.

Our concern over the soundness of the dollar as it appears to foreigners should not distort our perspective of the underlying strength and present position of the American economy. The persistent balance of payments deficits which have given rise to these holdings of dollars which bulk large relative to our gold have not reflected an inability to compete in world markets--our surplus of exports over imports is fairly large. They have instead reflected our foreign investment, lending, and aid programs. We have created a situation, not unfamiliar to bankers, where our long term claims on foreigners are greatly in excess of their claims upon us, but their claims, being largely short term, are enough to make us nervous in view of the size of our ready-cash position. There is an enormous difference between being in the poorhouse and being illiquid, and even the visiting analyst from Switzerland, that home of solid money and cheese with holes, will have difficulty picturing the United States as a country with economic problems on the order of those of some of his neighbors. We have not had a major depression in the postwar period, contrary to widely held expectations at the end of World War II, and our capacity to produce not only goods but services has permitted our living standards to be raised relatively steadily, even though we are carrying the significant burdens of both a foreign aid program and an increased defense establishment, necessitated by a troubled world.

If we are to continue to have, as we must, a strong economy that will support whatever defense measures may be necessary in the difficult period ahead, we

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must reduce unemployment and encourage further economic growth. But if boom is not to be succeeded by bust, these things must be done without inflation. Depression is not an alternative to inflation as some would argue; it is much more likely to be the consequence of it.

Certainly, we all recognize the economic wastes involved in idle men and machines; and we can pay dearly for lack of appropriate action. However, let us also not lose sight of the fact that, while we want sustainable economic growth and accept as a responsibility shared by government the necessity of minimizing downswings in business activity, indiscriminate efforts to maintain maximum production and employment can rob us of the advantages of a dynamic economy. We want the kinds of goods and services being produced to change in response to changes in demand, as expressed both individually and collectively through government; we want new products and processes to find a place if they can compete successfully in the market with existing goods and methods. These things do not come about without friction. Change improves the economic position of some relative to others and tends to give rise to some ebb and flow in overall activity. We should be able, however, to keep such fluctuations within relatively narrow limits by appropriate monetary and fiscal policies, and by other government and private actions responsive to free markets and free men.

In conclusion, I would remind you of your stake, both as trust officers and as business leaders and advisers, in constructive solutions of these problems. Obviously you must be able to operate your trust departments in an economy in which expanding employment and incomes will provide profitable investment opportunities. You also require a climate in which people are willing, as well as able, to save, and in which a substantial part of their savings will be held in dollar claims. In these regards, your interests are those of the economy as a whole.

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You are trustees for individual funds; the Federal Reserve System is in a sense trustee for all our funds. This charge has been put upon us by the Congress, and in fulfilling this trust we have various objectives. These objectives, of promoting high-level employment, price stability, economic growth, and a sound international currency, are often difficult to assess and may at times appear to be inconsistent. In this respect, they are analagous to your objectives for your funds, of safety, stable purchasing power, growth, and/or high income. It is often necessary to ccmpromise between one objective and another, so as to achieve the best possible balance among them.

We must, as the central bank, operate through bank reserves in order to influence the money supply, and interest rates, in accomplishing our aim of best serving the people of this country. It should be clear, however, that we cannot rely exclusively on monetary policy to keep our economy moving in the right direction. Our economy rests upon dollar decisions of consumers, business, labor, and government. The influence of monetary policy upon the climate in which these decisions are made is far from negligible, but it is the responsibility of all of us to see that they are appropriate to the maintenance of our economic strength.

I cannot refrain from closing with a paraphrase of the words of a wise college professor. Upon his recent return from Russia, he acknowledged that he had continually been challenged with references to our country's excessive concern with material things, especially money, in contrast with the concern in Russia with people. Perhaps, he said upon reflection, that is why we lock up cur dollars and they lock up their people.

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